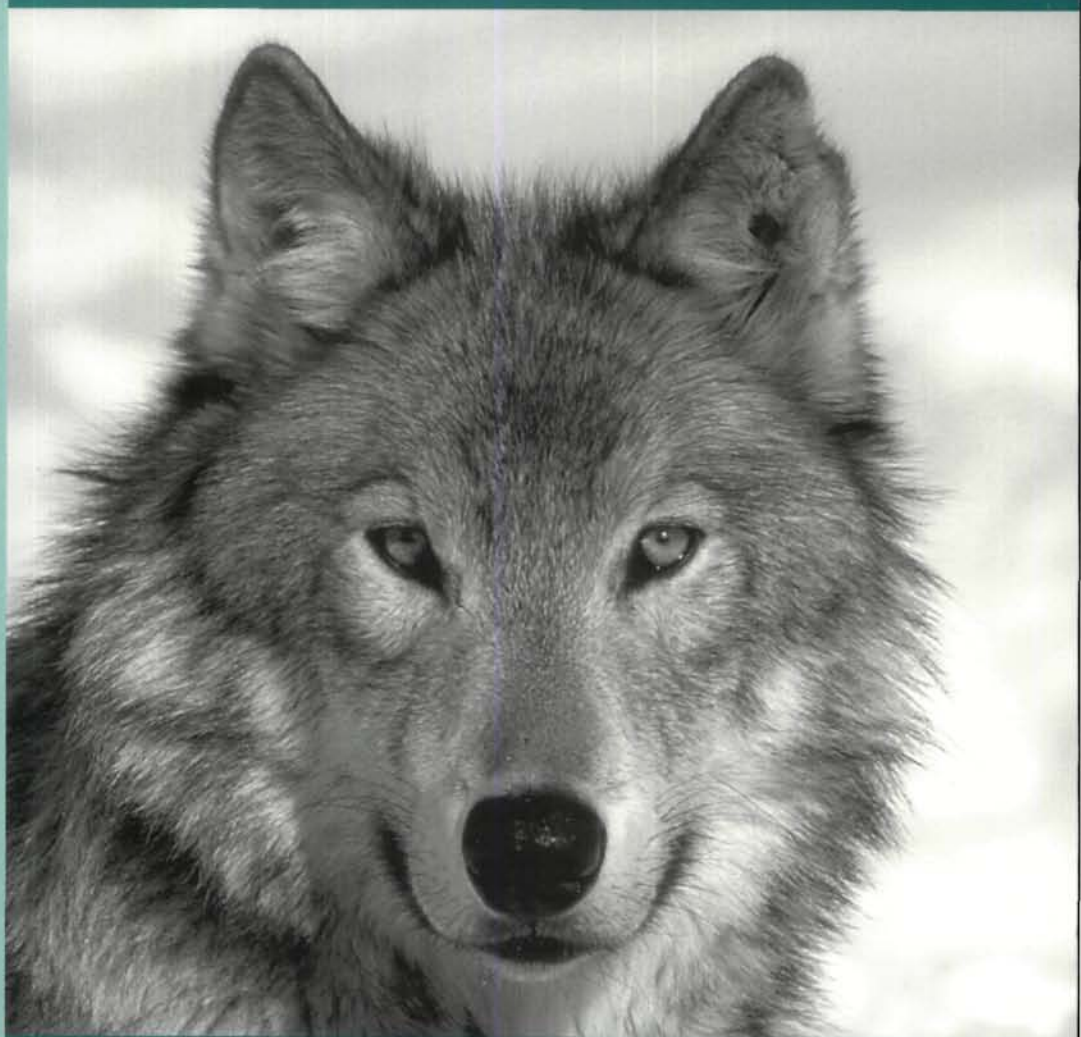
The INDEPENDENT REVIEW

A Journal of Political Economy



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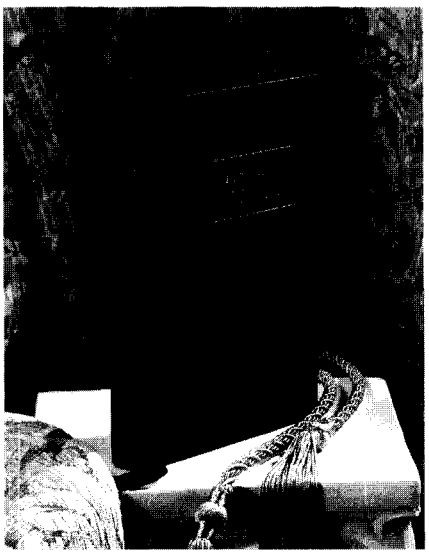
Classic Works for Readers Today

THE PURSUIT OF CERTAINTY
David Hume, Jeremy Bentham, John Stuart Mill, Beatrice Webb

By Shirley Robin Letwin



By examining the thought of four seminal thinkers, Shirley Robin Letwin in ***The Pursuit of Certainty*** provides a brilliant record of the gradual change in the English-speaking peoples' understanding of "what sort of activity politics is." As Letwin writes, "the distinctive political issue since the eighteenth century has been whether government should do more or less." Nor, as many historians argue, did this issue arise because of the Industrial Revolution or "new social conditions [that] aggravated the problem of poverty" but, Letwin believes, because of the "profoundly personal reflection" of major thinkers, including Hume, Bentham, Mill, and Webb. David Hume, for example, believed that to "reach for perfection, to seek an ideal, is noble, but dangerous, and is therefore an activity that individuals or voluntary groups may pursue, but governments certainly should not." By the end of the nineteenth century, as Letwin observes, Beatrice Webb came to "equate the triumph of reason over passion with the rule of science over human life." Thus did the "pursuit of certainty" displace the traditional English understanding of the limitations of human nature—hence the necessity of limits to governmental power and programs. Consequently, in our time, "Politics was no longer one of several human activities and at that not a very noble one; it encompassed all of human life" in quest of philosophical "certainty" and social perfection. The Liberty Fund edition is a reprint of the original work published by Oxford in 1965.

Shirley Robin Letwin (1924–1993) was a Professor of Political and Legal Philosophy at Harvard, Cambridge, and the London School of Economics.

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Of Stranded Costs and Stranded Hopes

The Difficulties of Deregulation

FRED S. MCCHESNEY

Given the manifest inefficiency of government regulation, why is there so little deregulation? Of course, some deregulation, including the privatization of state-owned industries, has occurred in recent decades. The United States experienced a spate of high-profile deregulations from 1978 to 1980 in the natural gas, trucking, and airline industries (Crandall and Ellig 1997). In Europe, deregulation has occurred concurrently with, and often as part of, the privatization of numerous sectors of the economy.

But the observation that deregulation has occurred in some markets in some places naturally raises the question, Why has it not occurred in all markets, everywhere? In America, deregulatory passions have cooled, leaving the vast bulk of regulated industries untouched. If one added the failures to privatize industries such as the postal service and east-coast railroad service, plus the current to-and-fro over deregulating electricity supply in different states, the list of missed opportunities for deregulation would be even longer. Even that staunch free-marketer, Ronald Reagan, achieved little in the way of deregulation. And in some areas where government control of the economy fell during the 1980s (notably in telecommunications) the reductions have proven to be only temporary respites or are constantly threatened. Much telephone deregulation in particular has turned into reregulation.[1] The Contract with America announced by the Republicans in 1994 to reduce government regulation is now just a rueful memory.

Fred S. McChesney is a professor in the Law School at Cornell University.

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Why is deregulation so hard to achieve? I shall suggest several reasons. Perhaps the most interesting ones pertain to the potential gains from deregulation, which, I maintain, are often smaller than they are believed to be. In short, deregulation may not be worth the candle.

Two preliminary points merit emphasis. First, the analysis here is positive. It attempts to explain as a purely descriptive matter why there is often little pressure for deregulation. No broad normative conclusion is advanced (or warranted) that deregulation is not a good thing or that it should never be attempted.

Second, no one positive explanation for the frequent lack of enthusiasm for deregulation suffices. One grand theory of deregulation would be more satisfying intellectually, but a single model cannot explain the difficulty of reversing regulation. This condition should hardly be surprising. After all, there is no unitary model of regulation, either, despite certain economists' habit of speaking of "*the* economic theory of regulation." Rather, economists have gone from a relatively simple model, which explained some regulation well and other regulation not at all, to a plethora of models developed in more ad hoc fashion to explain practically all forms of regulation (Aranson 1990). Greater coverage has been achieved at the cost of universality. So it is in explaining deregulation, or the lack thereof.

Regulation, Transaction Costs, and Deregulation

The Nature of the Problem

The issue of deregulation arises only when regulation has already occurred. Social scientists have extensively analyzed how and why regulation occurs (Aranson 1990; McChesney 1998).

In the simplest model, depicted in figure 1, producers seek regulation in order to raise prices from the competitive level P_c to some regulated level P_r. The higher price reduces the amount of the product purchased from Q_c to Q_r. Consumers lose in two ways. Area I (the "Tullock rectangle") represents the monetary transfer from buyers to sellers caused by the higher price.[2] Area II (the "Harberger triangle") is the dead-weight consumer-welfare loss that results because marginal consumers forgo purchasing the product even though the price they are willing to pay exceeds the marginal cost (*MC*) of producing the product (Harberger 1954).

Thus, regulation causes losses to consumers (areas I + II) that exceed the gains to producers (area I only). In effect, regulation represents a political-market failure. Buyer-losers would always be willing to compensate seller-winners *not* to be regulated. In a

1. "Undoubtedly, the greatest surprise in telephone industry deregulation has been the absence of deregulation, for the industry continues to be almost as highly regulated today as twenty years ago" (Crandall 1988, 78).

2. Although area I was originally treated as a transfer, Gordon Tullock argued in a seminal article on rent-seeking (1967) that much, if not all, of area I represented dead-weight losses because producers would expend resources in the competition for regulatory advantage.

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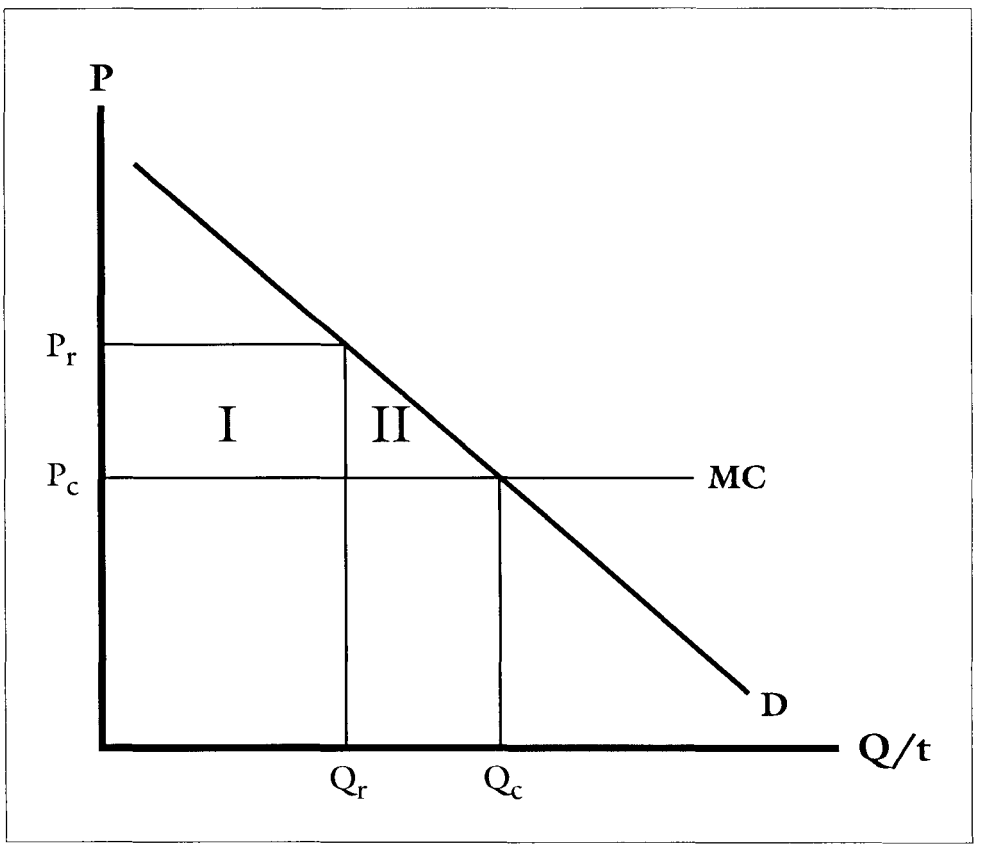
purely Coasean world of zero transaction (including information) costs, regulation would never occur. As in all Coasean analyses, to explain the outcomes actually observed—in this case, the fact that regulation does indeed occur—the analyst must focus on the nature of transaction costs (Wenders 1987; McChesney 1991). Why does the political marketplace malfunction so that consumers do not purchase the right to be unregulated?

The conventional answer focuses on the relative organizing costs of the potential winners and losers from regulation. Consumers are more numerous than producers, so they have a greater incentive to free-ride on the efforts of others to fight off onerous regulation. Hence, producers work harder to get regulation than consumers do to oppose it. Likewise, individual consumers lose little if each pays $1 more for a widget. An individual consumer therefore has little incentive to fret about regulation. In contrast, the producer who sells a million widgets a year at the higher price cares intensely about the extra $1 million he will earn under regulation. Finally, with only a $1 loss at stake, consumers may be rationally ignorant of regulation's potential impact on them in the first place (McCormick, Shughart, and Tollison 1984).

Figure 1: Regulated Market



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In any particular case, it may be unclear which (if any) of these factors—greater free-riding, disaggregated losses, and rational ignorance among consumers—truly explains the particular regulation under scrutiny. For present purposes, the important point is that the very existence of regulation indicates that *some* impediment to informed, low-cost contracting exists. The onset of regulation attests to some contracting failure in political markets.

A Possible Solution: Demand-Driven Deregulation

It follows that deregulation will not come about unless the market-failure reasons for regulation abate. But it is far from likely that conditions will change in any important way. Given economies of scale in production—one specialized supplier can produce many more of an item than a single consumer will want—producers of any given product will practically always be fewer than consumers of that product. Producers therefore will almost always face less free-riding than consumers and therefore will be more intensely interested in maintaining regulation than consumers will be in removing it. Rational ignorance among consumers will not change as long as consumers' stakes are so small. "To the extent that regulation persists, equilibrium indeed must be inferred" (Crew and Rowley 1988).[3]

Here, then, is the first reason why so little deregulation occurs. The very fact of regulation indicates the presence of conditions sufficient for its existence—conditions such as producers' superiority in numbers and knowledge, plus their more intense preferences. Those conditions are unlikely to change in most markets, although, of course, they might change. In a careful cross-sectional regression model, deregulation of state telephone services has been shown to be a function of differences in interest-group variables across states (Kaserman, Mayo, and Pacey 1993). Likewise, one frequently hears (among economists at least) that airline deregulation occurred because it was increasingly easy for consumers to see (i.e., increasingly difficult for them to remain ignorant) that regulation increased air fares. So many instances of nonregulation provided information about lower fares that consumers' growing knowledge finally tipped the balance against continued regulation. Moreover, those who stood to gain from deregulation, regular airline customers, are a much smaller, more intensely interested group than consumers generally.

Still, it is hard to believe that American consumers are any less informed now about the effects of, say, Food and Drug Administration (FDA) drug regulation than they were of the effects of airline regulation in the 1970s. The problems of drug regulation—the extraordinarily time-consuming and expensive process of getting the FDA to approve a new drug, the fact that other countries approve drugs faster with no

3. For a more formal and extended treatment of this point, see Peltzman 1976. The point is similar to that of Becker (1983), who argues that what is must be efficient, or else a different state of the world would be observed. But Crew and Rowley's point (like Peltzman's) is positive, whereas Becker's is normative.

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apparent impact on drug safety—are reported frequently in the popular media. Those seeking access to specific drugs (e.g., Laetrile some years ago) are often a relatively small, intensely interested group. Thus, although the "changing-conditions" model furnishes a plausible theory of deregulation after the fact, it does not provide a convincing, predictive model ex ante.[4]

One final aspect of the demand-driven deregulatory sequence must also be recognized. The very existence of regulation not only indicates that proponents of regulation outweigh opponents politically, but it sets in motion a process that over time increases the number of those favoring continued regulation. Even those who initially might lose from regulation are often brought into the rent-creating deal later, and then switch from being opponents to being proponents of regulation. Union workers, for example, will demand at the collective-bargaining table a cut of firms' regulatory rents, and they can get their cut because by shutting down the firm they would prevent the firm's owners from getting the rents promised by regulation (Rose 1987). Regulation might hurt labor generally, by reducing production and therefore the demand for labor services, but organized workers share with firms' owners the rents created by regulation and therefore join the owners in opposing deregulation. Similarly, telephone regulation has involved considerable cross-subsidy of residential customers by business firms, with the result that home telephone customers oppose deregulation in the telephone industry (Kaserman, Mayo, and Pacey 1993). Those who specialize in rent-seeking (e.g., lawyers, lobbyists), facing devaluation of their services if rent-creating regulation is less durable, will fight deregulation. Regulation, once attained, thus creates its own defenders, who are more numerous than those who initially benefited.

The Transitional Gains Trap

The possibility that changes in consumer organization, preference intensity, or information might spur a drive for deregulation relates to potential demands for deregulation. Absent some change along those margins, there is little reason to think that politically relevant demands for deregulation will materialize very frequently once regulation has been imposed. Even if consumers' demand for deregulation did increase, however, that greater demand is only a necessary, not a sufficient, condition for deregulation. A disequilibrating increase of consumers' demand for deregulation predictably will be offset (at least partly, perhaps fully) by an increase of producers' demand to retain the regulation. Indeed, the very preexistence of regulation gives rise to a supply-side opposition to deregulation.

4. Moreover, the "changing-conditions" model is essentially tautological. After the fact, when deregulation has already occurred, it can be ascribed to a reduction in transaction-information costs. When no deregulation occurs, it will be said that the conditions have not changed. By definition, given the deadweight losses of regulation, these statements must both be true.

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The Trap

Gordon Tullock (1975) was the first to appreciate the trap that regulation creates for future attempts to deregulate. He noted that regulated firms often are not unusually profitable, even in industries (such as taxicabs) where entry is explicitly limited and prices set at supracompetitive levels. This seeming anomaly occurs because markets capitalize the discounted present value of regulatory rents into current firm values. Thus, only the firm's owners at the time of regulation experience a wealth increase. Subsequent generations, who buy into the regulated industry (e.g., by purchasing taxi medallions or the shares of already regulated firms), can expect only normal profits, because the entire value of the Tullock rectangle expected to accrue over time has been reduced to its discounted present value today. Gains to the first group of owners are merely "transitional"; later owners' gains are zero.[5]

Tullock's insight contains two lessons for deregulators. First, newcomers to the regulated industry can earn supracompetitive returns only by imposing *new* regulations, not by operating under the old regulations, whose value has already been captured by the old owners. But those who would increase regulation (for example, by a second round of price increases or entry restrictions) face the same regulatory equilibrium that partisans of deregulation face. As previously noted, regulations that have been in place for a while presumably represent an equilibrium outcome that balances the interests of gainers (firms) and losers (consumers). That very equilibrium explains why regulated industries tend not to get increased regulation any more than they get decreased regulation. Regulatory regimes, once established, tend to be stable.

Second, and perhaps more important for the deregulation issue, the transitional character of the regulatory gains creates the "trap" to which Tullock called attention. Although subsequent purchasers (of medallions, shares, and so forth) may not earn greater-than-competitive returns from their investment, they certainly will suffer a wealth loss if regulation is abolished, causing entry barriers to be removed and prices to fall to their competitive levels.

> One possible way out of the trap, the phasing-in of deregulation, while on the face of it promising, is fraught with problems. Suppose that New York announces a phased deregulation of taxi cabs. The immediate effect is an outcry amongst cab owners. They begin to lobby the mayor and the council, and law suits are initiated. The value of the medallion falls by the present value of the reduced profits expected from increased entry plus the extra cost medallion

5. The gains are transitional because they are capitalized and thus realized only by the first generation of firm owners. Gains may also be transitory because not all avenues of competition are regulated. For example, higher prices and restricted entry would induce taxicab firms to increase the number of drivers and hours beyond their optimal points in search of the higher-priced business, raising costs and thereby reducing the gains from regulation.

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> owners incur to protect themselves from the deregulation and to reverse it. The effect has been to increase welfare losses. (Crew 1987, 159)

In other words, deregulation may be socially beneficial overall, but it is not universally beneficial. The gross gains from deregulation must be netted out against the costs that current firm owners will bear to avoid losing regulation, even though they are earning no supracompetitive returns. As Tullock summarizes,

> It is hard for an economist to recommend any positive action to deal with this sort of situation. It is, as the title of this article suggests, a trap. I can recommend very strongly that we try to avoid getting into such traps in the future, but what about the ones into which we have already fallen? In those cases where there are efficiency gains from reorganizing [i.e., deregulating] the industry, we could presumably compensate the present beneficiaries; but the political possibilities seem to me to be very small. . . . As to its political practicality, I take it I do not have to explain why I think it is low.
>
> The moral of this, on the whole, depressing tale is that we should try to avoid getting into this kind of trap in the future. Our predecessors have made bad mistakes and we are stuck with them, but we can at least make efforts to prevent our descendants from having even more such dead-weight losses inflicted upon them. (1975, 677–78)

These costs are the flip side of the rent-seeking costs identified in Tullock's seminal rent-seeking article. Just as the first generation of firm owners expended resources to obtain rents from regulation, so will subsequent generations of owners spend resources to avoid deregulation.

Compensation for Deregulatory Takings: The "Stranded Cost" Controversy

Tullock's reference to political obstacles raised against compensating the losers from deregulation may seem strange to some. Why does it matter economically whether losers are compensated or not, if deregulation increases efficiency by lowering prices and thus removing the dead-weight loss of regulation? Compensating losers raises only distributional issues, which might seem economically irrelevant if allocative gains can be achieved.

But the matter is not so simple. Throughout the deregulatory episodes of the 1970s, a fundamental property-rights issue arose repeatedly. As Tullock himself wrote, the difficulty in deregulating is not just a positive matter of entrenched interests, such as taxi-medallion owners, exerting political pressure in favor of the regulatory status quo. "In a very real sense they have established property rights in a system that is the creation of the New York City government" (Tullock 1993, 67).[6]

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When government alters the legal rules concerning competition in an industry, should compensation be paid to those whose assets (e.g., medallions) lose value? Particularly in the context of current attempts to deregulate electricity supply, this issue has become most contentious, giving birth to a new name: stranded costs. The term is defined somewhat differently by different analysts, but basically "stranded costs could be defined as any investment that will be less valuable under competition than under regulation" (Maloney, McCormick, and Sauer 1997, 59–60). As one study notes, it is "odd that little or no attention was paid to stranded costs in the discussion on airline deregulation, trucking deregulation, and the breakup of AT&T" (Maloney, McCormick, and Sauer 1997, 59). But, perhaps because of their sheer magnitude—reportedly $28 billion in just one state, California—debates over stranded costs now animate legal, economic, and political debates over deregulating electricity supply (LaBorde 1998).

Indeed, it is the overlap of law, economics, and politics that makes the stranded-cost controversy so thorny. Legally, the argument arises in two forms. First, it is said that the Fifth Amendment's constitutional prohibition against governmental takings applies to deregulation that leaves investors with stranded costs. Traditionally, the Fifth Amendment has been applied to takings, especially governmental condemnation of land, that facilitate production of so-called public goods (e.g., roads, bridges, and dams).[7] But it is argued as well that deregulation is a taking of property rights that demands compensation of the losers (Sidak and Spulber 1996). Total deregulation of New York City taxis, for example, would reduce the value of medallions to zero, just as would outright confiscation of the medallions themselves. As the argument goes, the confiscation requires compensation under the takings clause, and so must compensation accompany any deregulation that leaves stranded costs.

In addition to the constitutionally based argument, stranded-cost proponents contend that deregulation bears a likeness to breach of contract, in this instance the supposed "regulatory contract" between government regulators and private regulated firms.[8] The legal argument here is both normative and positive. Normatively, it is argued, an implicit contract exists between investors in regulated industries and their regulators, such that lost investment value should be reimbursed: "Investors in the network industries made investment in large-scale facilities in the expectation that they would receive from regulators the reasonable opportunity to recover those investments plus a competitive rate of return" (Sidak and Spulber 1997, xiv). Positively, it is

6. Tullock went on to note an irony: "Experience indicates, however, that it is much easier to attack the property rights of those who have succeeded in private competitive markets than it is to restore such rights to those who have had them seized" (68).

7. Concern has focused more recently on governmental takings that serve private interests (for example, construction of a factory or sports stadium) and on whether payments made to the victims of governmental takings are truly compensatory. The already classic discussion is Epstein 1985. See also Haddock and McChesney 1991.

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claimed, courts have recognized the existence of the "regulatory contract," a claim with which others disagree.[9]

The legal case for the existence of property rights in regulated firms, such that deregulation legally requires compensation for stranded costs, is at present contested. Not all scholars agree that, as a matter of constitution or contract, compensation for stranded costs is required, and certainly no court has held that compensation must generally be paid. But the legal ambiguities have not stopped proponents of reimbursing stranded costs from inserting claims for compensation into deregulatory proceedings, as Tullock predicted the deregulatory "trap" would impel them to do.

The economics of the stranded-cost issue seem more straightforward. The economic argument is woven from several strands. First, as to the supposed "regulatory contract," the basic economics of regulation indicate that no compensation for stranded costs is warranted. The very reason that deregulation is desirable is because regulation has restricted output and raised prices. As illustrated in figure 1, regulated industries have been charging supracompetitive prices all along, which implies that investors in industries about to be deregulated have already been compensated. "That firms are currently receiving price exceeding the anticipated competitive equilibrium price means that output price is greater than the minimum average cost of production. The conclusion is that firms are receiving stranded cost recovery *now*" (Maloney, McCormick, and Sauer 1997, 69; emphasis added).[10] To pay investors again when deregulation arrives is to compensate them twice.

Payment for stranded costs would be overcompensation for another reason, too. Surely, no one would claim that the capital markets in which public utility bonds and shares trade are inefficient. In efficient capital markets, investors assume the risk of deregulation and receive compensation for bearing it. That capital markets operate to price risk is demonstrated by the markets' reaction to other risk-related events such as the Three Mile Island accident (Maloney and Sauer 1998, 5).[11] Again, because risk is compensated ex ante, it would be excessively compensatory to pay investors for stranded costs ex post.[12]

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8. See Sidak and Spulber 1997:

> The sweeping deregulation of public utilities being proposed and implemented at the state and federal levels promises to bring the benefits of competition to markets for electric power and telecommunications. Those benefits include improvements in operating efficiencies, competitive prices, efficient investment decisions, technological innovation, and product variety. The benefits of competition, however, do not include forced transfers of income from utility shareholders to their customers and competitors as a result of asymmetries in regulation. . . . As regulators dismantle barriers to entry and other regulatory restrictions, they must honor their past commitments and avoid actions that threaten to confiscate or destroy the property of utility investors on an unprecedented scale. (1)

9. Perhaps the most important case in this respect is *United States v. Winstar*, 116 Supr. Ct. 2432 (1996). Scholars differ, however, on the reading of *Winstar*. Compare Sidak and Spulber (1997, 171–77) with Baumol and Merrill (1997, 1037).

10. Regarding the alleged "regulatory contract," the authors continue, "there also exists a compact between citizens and their government. . . . Producers and consumers were supposed to get competitive prices as part of the bargain" (84).

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"Paying such investors for losses due to policy changes is equivalent to offering refunds to holders of losing lottery tickets" (Sansing and VanDoren 1994, 565, 567).

The preceding observations only scratch the surface of what has become a heated debate about whether compensation should accompany deregulation. Some economists, even noted deregulators such as Alfred Kahn (1998), agree normatively that stranded costs matter.[13] Others disagree strenuously.[14] For purposes of the present article, however, it is the very existence of the debate, rather than the merits of the respective arguments, that is important.

With respect to the difficulty of deregulation, three points are paramount. First, the stranded-cost debate pertains largely to distributional rather than allocative issues.[15] "While stranded costs may have important financial consequences for a select group of utilities, both theory and history suggest that the impact on the production of electricity will be negligible" (Maloney, McCormick, and Sauer 1997, 83).

Second, those affected by deregulation naturally care much more about the distribution of gains and losses than about any allocative implications.

> Of course, in a no-compensation regime, policy changes do create wealth loses ex post. Those who suffer wealth losses as the result of the policy change often feel that they have been unjustly treated and are likely to organize and attempt to block the enactment of policies that increase total social welfare but cause transitional losses. (Sansing and VanDoren 1994, 567)

Thus, because it adds new issues and new players to the deregulation debate, the stranded-cost controversy has baleful implications for the transaction costs of achieving deregulation.

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11. Another example of ex ante compensation for risk, in the New York City taxicab industry, is provided by VanDoren: "Investors behave as if the probability of deregulation of the taxi industry is 5 percent annually or 100 percent over a 20-year period, even though additional medallions have not been created since 1937" (1998, 10–11).

12. "This approach treats a wealth loss from a policy change no differently than a wealth loss from a change in market conditions, such as a decrease in the demand for product due to technological innovation. Exposure to such risks is a part of normal business risk, for which the market compensates ex ante" (Sansing and VanDoren 1994, 567.

13. Hal Hochman (1974) wrote, "To charge investors with responsibility for full discounting of the risk of changes in 'inefficient' rules is, for my taste, too facile. It turns public confidence in property rights into a gamble, thus making mockery of the rule of law."

14. See, for example, Maloney and Sauer 1998; Maloney, McCormick, and Sauer 1997.

15. This is not to say that allocative arguments are not made. It is claimed (e.g., by Goldberg 1976) that, because of specificity of assets and the possibility of contractual opportunism by regulators, regulation should be viewed as a contractual safeguard against deregulatory surprises that prevent recovery of investments made under regulation. "Powerful efficiency arguments demonstrate why one would expect the regulatory contract to have evolved. The regulatory contract contains three essential terms—price regulation, entry regulation, and the obligation to serve—that simultaneously constrained the private exercise of market power and ensured that the utility would have a reasonable opportunity to recover the economic costs of the long-lived, nonsalvageable investments that it made to serve its customers" (Sidak and Spulber 1997, 177).

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Dealing with stranded costs raises the administrative cost of deregulation. Compensating investors for investments whose value will tumble with deregulation is required. To think of deregulation as entailing some sort of free lunch—an instantaneous and costless movement from Q_r back to Q_c in figure 1—is to commit the nirvana fallacy with respect to regulation. The normative disagreements, be they legal or economic, are less important than the fact that the arguments, positively speaking, have been taken seriously, legally and economically, and hence have retarded and confined deregulation. There are important transaction costs of shifting from a regulated to a deregulated regime.

This observation raises a more ominous point concerning the nirvana fallacy. Transaction costs might be viewed as just an inevitable cost of attaining efficiency, even with public-spirited, efficiency-maximizing legislators and bureaucrats enacting and implementing deregulation. But in the real world of self-interested individuals and political pressure, deregulation does not occur disinterestedly. Rather, the process of deregulation is inherently a political one, because dismantling the regulatory apparatus opens the door to bestowal of political favors, just as regulation itself bestowed rents. That deregulation is under way indicates that the prior regulatory equilibrium has dissolved. There is no reason to expect that the movement to a new equilibrium will be a movement to some social optimum—*au contraire*.

Telecom deregulation that followed judicial dissolution of the government-sponsored AT&T monopoly illustrates the point. Government has explicitly followed a deregulatory policy that favors some firms by keeping other firms out of certain parts of the industry. For example, "quarantine" restrictions have prohibited local telephone firms (the "regional Bell operating companies," or RBOCs) from providing long-distance services in competition with AT&T, MCI, Sprint, and other specialized long-distance firms (Sidak and Spulber 1997, 55). At the same time, the RBOCs have successfully pushed to keep long-distance carriers out of local service. "This result, barring entry into other markets, is truly an exceptional outcome to an antitrust case" (McChesney 1995, 493). Many other legal-political obstacles to true deregulation have developed in the telecom industry (Crandall and Ellig 1997, 30–31).

Deregulatory politics would predictably play a role in compensating stranded costs. The same regulators who are to decide on appropriate compensation for stranded costs (i.e., investments made under regulation that, under deregulation, will fail to recover their costs) are the ones who are impeding competition under regulation. In fact, it is the inability of regulators to get the price right that spurs the demand for deregulation in the first place. In view of their having gotten the price wrong as regulators, why suppose they will get it right in compensating the losers from deregulation? More likely, the losers under regulation will also be the losers under stranded-cost compensation.[16]

In that respect, it is worth noting that there is no agreement as to exactly what the measure of compensation for stranded costs (if compensation be made) ought to

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be. Oftentimes, measurement of investor loss seems to proceed in terms of lost revenues due to deregulation (e.g., MacAvoy 1998). But true investor losses should be measured by stock-price changes, which will reflect only losses due to unsystematic risk. To the extent that utility owners have, or could have, diversified against losses from deregulation by investing in other securities, no compensation would be appropriate (Sansing and VanDoren 1994, 568–69). One must wonder whether regulators, themselves used to analyzing revenues and costs but not stock-price effects, can be trusted to proceed correctly.

In any event, one must recognize that deregulation is (*a*) costly in a world in which regulators (legislators and bureaucrats) perform public-spiritedly to maximize efficiency or social welfare, and (*b*) even more costly if legislators and bureaucrats deregulate in non-public-spirited ways. Discussions of deregulation commit the nirvana fallacy when they suppose it to be costless. To the extent that deregulation is costly, people demand less of it. Then, predictably, government officials supply less deregulation. At the margin, expected residual value may be insufficient to motivate the initiation of deregulation.

Irretrievable Costs: The Ghost of Rent-Seeking Past

Tullock's explanation of the transitional gains trap compels us to appreciate that the losers from deregulation will—often credibly—demand compensation for their losses, reducing the net gains from deregulation. The ongoing stranded-cost controversy shows that investor claims for remuneration may have legal justification, whatever the purely economic merits of the claims, so that even disinterested public officials might respond to those demands. The losers from deregulation may well get preferential treatment from deregulators. All these phenomena reduce the gains from deregulation that would otherwise accrue.

The Potential Gains from Deregulation

But how great are those gains to begin with? Robert McCormick, William Shughart, and Robert Tollison (1984) have argued that, under certain plausible conditions at least, the gains are minimal. They note that standard analysis of deregulation treats it as a return to the status quo ante. In other words, only two states of the world are

16. Alfred Kahn (1998) warns more generally of the problems for deregulation created whenever regulators are left in place to "assist" in deregulation. He warns in particular of the bureaucrats' incentives to "micromanage" competition (for example, by deciding who will be allowed to compete and on what terms) rather than just ending regulation and letting the market find its own way. But Kahn is somewhat inconsistent on this point, advocating a continuing regulatory function for antitrust-type problems such as alleged "essential facilities" potentially possessed by some deregulated firms. "Just as efficient competition must be conducted on the basis of the relative efficiencies of the several contenders, so must it be unbiased by the exercise of monopoly power to exclude rivals from the opportunity to compete on that same basis. Arguably, this function might be left to the antitrust laws. But protection of captive ratepayers remains the continuing responsibility of regulatory commissions" (35–36).

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posited, one regulated and the other competitive. But McCormick, Shughart, and Tollison argue that the deregulated world cannot be a return to the competitive status quo ante because the original shift from competition to regulation will have been associated with rent-seeking investments by regulated firms. Those costs are sunk—unrecoverable even in the event of deregulation.[17] For example, lobbyists' and lawyers' time has been expended to gain passage of regulatory legislation, time that could have been used to create rather than diminish wealth overall.

Two implications follow. First, the wealth lost in rent seeking is not recovered, or even recoverable, merely by abandoning the regulation. The economy's production possibilities have been irretrievably diminished by the rent seeking. For instance, the construction of more lobbying-related facilities (e.g., golf courses and restaurants) than is optimal without rent seeking has drawn on resources that cannot be returned costlessly to competitive production.[18]

Second, to the extent that the resources diverted to rent seeking were specialized in the production of the good ultimately regulated, the relative cost of producing regulated versus unregulated goods has risen irretrievably. Suppose, for example, that procuring the regulation of widgets requires the time of not just lobbyists and lawyers but also the presidents of widget-producing companies—hardly an extreme supposition. As executives spend more time in Washington or Albany and less time in the widget factories, less specialized capital becomes available to produce widgets in the later, deregulated world. The relative price of widgets therefore will be higher in the deregulated world: the price can never return to $P_c = M_c$ in figure 2. Under deregulation the price will be some $P_d = MC'$ (where $MC' > MC$), a price between P_r and P_c.

McCormick, Shughart, and Tollison's focus on the sunk costs of rent seeking presaged the current fascination with the stranded costs of deregulation. In effect, they pointed out that among the stranded costs are those (including the costs of investing in human capital) borne to secure regulatory favors, because the value of that capital is greater under regulation than under deregulation. Not only are those costs irretrievable; they distort subsequent production possibilities even in a deregulated world. Whereas the current stranded-cost debate revolves largely around distributional issues, the McCormick-Shughart-Tollison model reveals the long-run allocative consequences of those stranded costs. Those consequences occur whether investors with stranded costs are compensated or not.

McCormick, Shughart, and Tollison's analysis, which suggests that deregulation may have few if any benefits, is obviously provocative.[19] Upon reflection, its insights—admittedly counterintuitive at first—become more persuasive.

17. As discussed later, in note 20, this point has been disputed.

18. Mixon, Laband, and Ekelund (1994) find that the number of golf courses and restaurants in the capital cities of American states is higher, ceteris paribus, than the number in noncapital cities.

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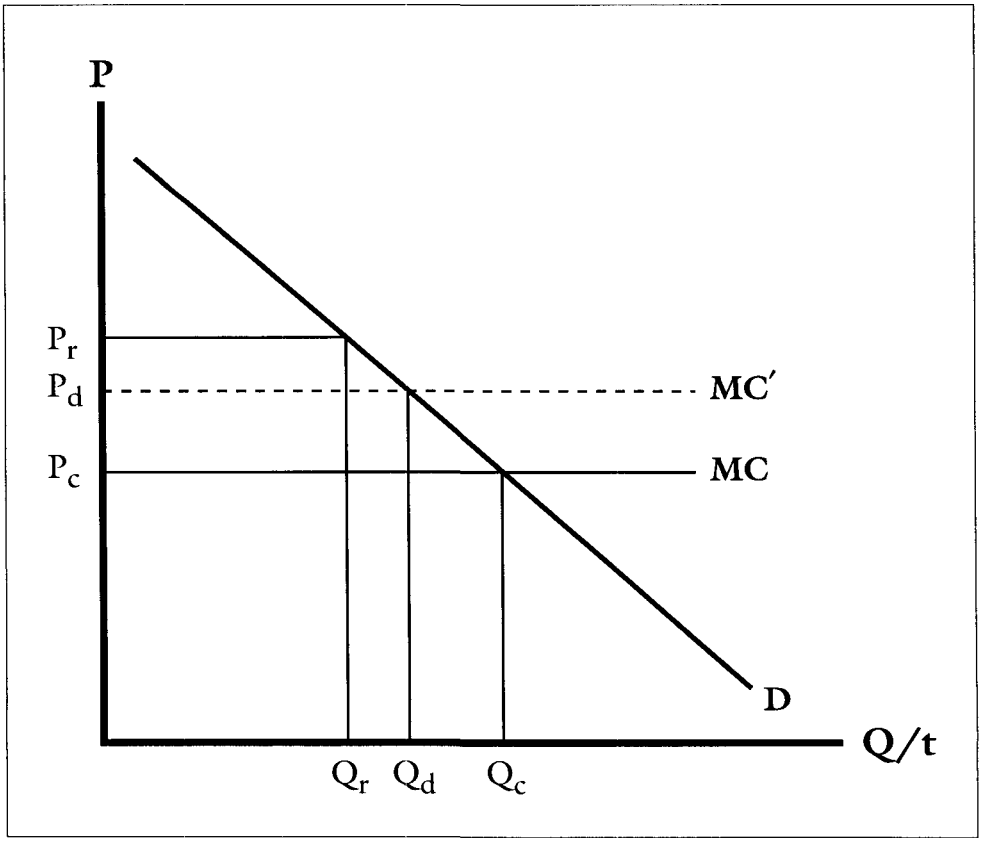
The economic intuition of our analysis is simple. The original act of rent seeking that created the monopoly employed, for example, the best and brightest legal minds in the industry. Moreover, legal skills were acquired that serve no purpose other than rent seeking. This reduces the human capital stock of lawyers with knowledge of industry practices such as contract negotiation and enforcement. When the industry is deregulated, the cost of obtaining additional output rises because legal inputs are now relatively less efficient at providing services to the industry.

This is just an example of the argument. The same point applies to other resources, especially managerial expertise and entrepreneurship, which are deflected from productive pursuits into the original act of rent seeking. It is, for example, fairly common to hear arguments that regulation drains managerial talents, dulling initiative and the incentive to innovate. On this account, marginal costs rise because the managerial talents acquired under regulation—dealing with regulatory bureaucracies, for example—are not

Figure 2: Deregulated Market



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> instantly adaptable to a deregulated environment. (McCormick, Shughart, and Tollison 1984, 1078)

The model depends on certain assumptions that may not always apply.[20] Nonetheless, it is remarkable how the methodologically—and substantively—different approach taken by McCormick, Shughart and Tollison leads to the same conclusion that Tullock reached by analyzing the transitional gains trap. Large gains can be had ex ante by preventing the imposition of regulation on competitive markets; the gains ex post from deregulation are relatively small. Stranded costs are really just a subset of a more general phenomenon indicating that deregulation can never replicate the status quo ante.

Finally, McCormick, Shughart, and Tollison note that the relatively large gains from stopping regulation in the first place versus instigating deregulation afterwards are reflected in the activities of free-market pressure groups:

> Efforts by political action groups, such as the Right-to-Work Foundation, stand to be a drain on society's resources. They cannot produce anything unless they prevent further monopolization through regulation. We do not, of course, expect these organizations to be ignorant of this principle. From a positive perspective, we expect them to allocate their efforts to prevent new regulations from appearing rather than to get old regulations abolished. Thus, groups such as the CATO Foundation and the Sierra Club will spend the bulk of their efforts on upcoming legislation, not on attempts to repeal old laws, even though those laws may have caused large losses to fiscal conservatives or to environmentalists. (1076)

That is, whatever regulation's losses have been, they are largely irretrievable once regulation has been imposed. Like Germany's offer in 1914 to restore Belgian neutrality after German troops had marched through Belgium to attack France, deregulation's promise to "restore" competition is "a feat that rates with the restoration of virginity" (Tuchman 1962).

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19. The article has been read as implying that deregulation is difficult because out-of-pocket marginal costs of production fall under regulation, certainly a position few economists would adopt. See Lott and Reynolds 1989. But McCormick, Shughart, and Tollison do not espouse that position. Rather, they focus on changes in relative prices due to past resource allocations. The relative costs of production are permanently altered by regulation and the costs incurred to achieve it.

20. Principal among these is the assumption that all rent-seeking costs of regulation have indeed been sunk, a point that has evoked dispute (e.g., Crew and Rowley 1988, 167):

> Only if the monopoly is continuously perceived to be completely durable would a normative efficiency case in favor of continuing regulatory monopoly necessarily coincide with political stability in favor of such an outcome. It cannot reasonably be inferred that all regulatory monopolies always reflect such durability characteristics in political equilibrium, even if initial rent-seeking outlays reflect such an expectation. Even the extreme forms of the rational expectations extravaganza allow for exogenous shocks that stimulate unanticipated performance adjustment.

McCormick, Shughart and Tollison (1984, 1076) admitted in their article that their assumption that all rent-seeking costs are sunk ex ante may not always hold.

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McCormick, Shughart, and Tollison's model supplements one's understanding of the importance of regulatory equilibrium in explaining the lack of interest in deregulation. As noted before, regulation itself must be taken to represent a political equilibrium in which producers have gotten from politicians some but (thanks to consumer resistance) not all of the benefits available from regulation. Only with changes in underlying parameters—consumer information, avoidance of the free-rider problem, and so forth—would a push for deregulation develop. But again, such changes are only necessary, not sufficient, conditions. Even if problems of consumer ignorance and organization are solved, McCormick, Shughart, and Tollison emphasize, no push for deregulation should be expected if consumers cannot recover through deregulation what they have lost via regulation. "It is not that potential gainers from deregulation are large in number, diffuse, heterogeneous, and face high organizational costs; rather, *they do not exist to any degree*" (1075, emphasis in original).

The Actual (or at Least Measured) Gains from Deregulation

The extent to which gains do exist is an empirical issue. How much do consumers really recover from deregulation? In figure 2, is P_d sufficiently far below P_r that consumers have an incentive to push for deregulation? Or is P_d so close to P_r that, as McCormick, Shughart, and Tollison's model indicates, the gains to consumers in pushing for deregulation are not worth their time and trouble?

It goes without saying that measuring the gains from deregulation entails assumptions and methodologies that may prove more persuasive to some than to others. But empirical observation is the only way to resolve empirical questions. Robert Crandall and Jerry Ellig (1997, 2), surveying a series of studies that analyze perhaps the four most important American deregulatory achievements of the late 1970s and early 1980s, arrived at annual values for consumer benefits due to deregulation (measured in both price reductions and service-quality increases) as follows: long-distance telecommunications, $5 billion; airlines, $19.4 billion; trucking, $19.6 billion; and railroads, $9.1 billion. The total annual benefits thus amounted to some $53 billion, or a total annuitized value of $758 billion at an interest rate of 7 percent (a conservative figure for the late 1970s and early 1980s, the years of deregulation). Assuming a population of 275 million Americans, that means an average per capita value into eternity for all four deregulations of about $2,750.

That sum is not a trivial, admittedly. But is it enough to induce individuals to devote considerable amounts of their own time and money to achieve deregulation? People do not live into eternity, but the present-value difference between, say, thirty years of benefits and an eternity of benefits is not immense. With a conservative assumption of an eternity of benefits spread over thirty years, the average annual consumer benefit per capita is only some $90 annually. If just half of consumers are voters or otherwise able to push for deregulation, that figure would be $180 annually. This,

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of course, refers only to that part of the Tullock rectangle recovered, not the (much smaller) Harberger triangle. Still, the amount is not overwhelming.

Of course, a margin of error surrounds these figures. One need not be a dyed-in-the-wool Austrian economist to register an important caveat to the calculations. Because the figures are necessarily based only on information currently available, they cannot capture all the dynamic gains—currently unforeseeable with any specificity—due to alterations in market structure, technological change, new information (including learning by doing), and other changes that predictably accompany deregulation. The airline industry of 1999 is not the airline industry of 1978 minus the Civil Aeronautics Board. As summarized by the authors of the study from which the preceding estimates are taken,

> Benefits of regulatory reform continued to accrue long after the market was first opened. Even if some firms adjust quickly to the deregulated environment, that environment changes much more quickly than the regulated environment. The industries in this study did not move from a "monopoly equilibrium" to a new "competitive equilibrium." Rather, they moved from a fairly stable regulated environment to an evolutionary environment in which competitive rivalry continually forces producers to improve their performance. Since it is unlikely that firms will ever stop learning, and consumers are never satisfied with the status quo, a stable equilibrium is extremely unlikely. (Crandall and Ellig 1997, 4)

One other point from the quoted passage deserves emphasis. As McCormick, Shughart, and Tollison emphasized, models of deregulation that assume the post-deregulatory world will be identical to the pre-regulatory world are suspect. Regulation itself gives rise to changes, so the particular market will never be the same. Europe was at peace at the beginning of 1939 and again at the end of 1945, but the continent had changed enormously in the interim.

On Being "Unregulated": Quasi Regulation and Rent Extraction

Apart from the impossibility of restoring a pristine competitive status quo ante, in most economic sectors no "competitive" market exists to begin with. Even in markets lacking prototypical economic regulation, governments constantly intervene via indirect regulation to achieve similar ends. Taxation is an obvious example of such "quasi regulation," increasing prices and, when applied discriminatorily (as it often is), restricting entry. Further, even without direct regulation or a quasi-regulatory surrogate, many markets must contend with simple extraction of rents by politicians. To the extent that quasi regulation and rent extraction substitute for direct regulation, the gains of "deregulation" are obviously smaller.

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Quasi Regulation

Although government does not directly regulate the prices of certain goods, from liquor and cigarettes to gasoline and airline service, it indirectly does so very effectively by imposing excise taxes. Moreover, government has often used excise taxation to erect entry barriers to benefit certain firms by excluding others. A classic example is the discriminatory tax imposed on margarine to favor butter producers:

> Caught in [a] vise of falling butter prices and rising competition from a new product, the dairy industry's response was predictable: they appealed to government for protection from "unfair" competition from the upstart oleomargarine manufacturers. The dairy industry's early rent-seeking success came with action by the states, especially the dairy states. In the 1880s, most states passed legislation regulating the manufacture and sale of oleomargarine, levied taxes on it, or both, while several states banned its sale altogether. Other states passed laws prohibiting manufacturers from adding yellow dye to the product, thereby making margarine less attractive. New Hampshire required the addition of an unappealing pink color. . . . Finally, in 1886, the industry was successful in getting a law passed by Congress and signed by the president requiring the licensing of manufacturers, wholesalers, and retailers of oleomargarine . . . and imposing an excise tax of two cents per pound. As a result of this legislation, the number of oleomargarine manufacturers dropped by more than a third. (Gifford 1997, 69–70)

A modern-day equivalent has been Congress's attempt to impose differential excise taxes on cigarette firms, in particular to favor one manufacturer (Brooke Group, formerly Liggett and Myers), which has shown itself willing to cooperate in federal and state government campaigns against cigarette companies (Bulow 1998).

Note that part of Big Butter's campaign against the margarine manufacturers included claims of "unfair competition." In addition to its power to tax otherwise "unregulated" industries, government's consumer-protection and antitrust powers likewise allow it to exert its influence over nominally unregulated sectors. There is little evidence that government price-fixing cases keep prices down, more that they actually raise prices (Sproul 1993; Marvel, Netter, and Robinson 1988). The same conclusion applies to mergers: no evidence exists that government enforcement policies have in any way enhanced competition; much evidence points the other way (e.g., Eckbo and Wier 1985).

Antitrust, however, is a valuable tool for politicians seeking to control the allocation of resources, including jobs in their districts (Coate, Higgins, and McChesney 1990). The examples are numbingly numerous. One involved the successful pressure by Nevada senators Richard H. Bryan and Harry Reid to keep Northwest Airlines from competing with local Nevada carrier Reno Air by opening new Northwest routes

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from Reno to the West Coast (McChesney and Shughart 1995, 341–43). The most obvious use of antitrust in quasi-regulating a nominally unregulated industry is the current Microsoft affair. The Justice Department's Antitrust Division would effectively reduce Microsoft to a regulated common carrier by requiring it to carry competitors' products in its Windows package and to display competitors' icons on the Windows opening screen. The suit represents a great victory for Microsoft's competitors (and their political backers), who for years have been importuning government antitrusters to "do something" about highly successful Microsoft.

Is quasi regulation a substitute for actual regulation? If so, the points raised by McCormick, Shughart, and Tollison apply with even greater force. The putative gains (lower prices, greater outputs) from deregulation would be lost to subsequent quasi regulation. This possibility is an empirical question, of course, one that has not been investigated systematically.

But anecdotal evidence indicates that at least sometimes quasi regulation replaces actual regulation. A crude indication is the continuing growth of government relative to the gross domestic product. Government taxing and spending have grown steadily as nominal regulation has declined through the deregulation of industries such as natural gas, airlines, and trucking.

Several examples are revealing. People seeking the regulation of guns seem largely to have given up on official regulation, seeking instead to reduce the number of guns by increasing their prices through excise taxes, as well as by pushing in the courtroom for strict liability against gun manufacturers and sellers for gun-related accidents (Kobayashi 1997). Perhaps the greatest example of the link between deregulation and quasi regulation, at least historically in the United States, is that of alcohol prohibition. Prohibition is simply an extreme form of entry-barrier regulation, one that greatly benefited some sellers (bootleggers, gangsters, foreign distillers) at the expense of others. Whatever the political reasons for enacting the regulation, it took only fourteen years for deregulation to occur, in the very first months of Franklin Roosevelt's administration. Roosevelt campaigned on the promise to repeal the restrictions on alcohol, promising to tax it heavily instead:

> Roosevelt's primary justification for increasing taxes was to generate additional federal revenues. The Depression had devastated the economy, and tax receipts were consequently down. . . . Realizing the revenue-generating power of liquor taxes, Roosevelt pledged to repeal Prohibition in order "to provide therefrom a proper and needed revenue." The Democratic party's platform had a very un-Keynesian theme: "If only given a chance, Americans might drink themselves into a balanced budget." (Yelvington 1997, 40)

Following the end of Prohibition, excise taxes on alcoholic beverages were imposed at almost double their level before Prohibition.

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If quasi regulation substitutes for actual regulation, some firms (and their customers) would rather be regulated. At the macro level, one would expect an overall substitution effect. Taxation predictably is a positive function of private social wealth produced; private wealth is a negative function of the extent of regulation. Less regulation (ergo higher wealth) should therefore translate into greater taxation.

Again, anecdotal evidence is illustrative. The tobacco companies hoped that placing cigarette warning labels on cigarettes would protect them from the sorts of quasi-regulatory depredations now being visited upon them by state and federal governments. And for a while, their hopes were realized. It is clear that banks would rather have their mergers officially regulated by banking regulators than expose themselves to the quasi-regulatory world of antitrust merger enforcement. Indeed, the Bank Merger Act of 1966 was an explicit attempt to undo the effects of a case brought by the Antitrust Division that declared a bank merger illegal (*United States v. Philadelphia National Bank,* 374 U.S. 321 [1963]). In any event, negative correlation between regulation and taxation is an empirical hypothesis that warrants systematic testing.

Rent Extraction

Is a market that is neither regulated nor quasi-regulated necessarily a "free" market, that is, a "competitive" one in the classical economic sense? By definition, unregulated markets seemingly would have to be classified as free. But actually, that conclusion does not follow. Unregulated markets often remain so only because producers or consumers pay politicians to leave them alone. Just as there are no free lunches, so there are no free markets.

Examples are ubiquitous. Various industries pay politicians—quite legally, it should be added—*not* to be taxed. Microsoft, it is widely reported, has now increased considerably its political contributions in hopes of being left alone by state and federal regulators. The (unregulated) cosmetics industry employs lobbyists in Washington who pressure Congress *not* to regulate the industry. American banks lobby the Federal Election Commission to curtail their ability to make loans to politicians. One banking company alone, Citicorp, employs registered lobbyists and several law firms in Washington to fight off various proposed credit regulations.

Paying not to be regulated is known as *rent extraction,* in contrast to *rent creation,* the hallmark of regulation (McChesney 1997 and forthcoming).[21] Just as rent creation via regulation is not merely a wealth transfer to producers but entails true allocative losses, so does rent extraction involve more than just wealth transfers to politicians. It distorts investment decisions, because some wealth is more easily threatened than other wealth, and it soaks up real resources (e.g., lawyers, lobbyists).

21. My 1997 book also discusses the examples noted in the previous paragraph.

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Modern health, safety, and environmental regulation have given politicians particularly potent threats to induce payments to avoid regulation. The NIMBY ("not in my back yard") response means that individuals lobby legislators hard, for example, to have toxic dumps placed somewhere else (Yandle 1989).[22] In Louisiana, environmental violators located in districts represented by important legislators face higher threatened fines for their infractions, ceteris paribus, but those threats typically are alleviated (Kleit, Pierce, and Hill 1998). The point is not necessarily that the regulation has no benefits, but rather that its mere threat is sufficient to induce payments and produce costly economic distortions.

The real issue here, however, is again whether deregulation increases the amount of economic loss due to rent extraction. Rent extraction and rent creation are not mutually exclusive. Politicians can create rents for an industry but extract some portion of the industry's existing wealth at the same time. But if deregulation would predictably lead to an increase in rent extraction, the gains from deregulation would be smaller and so less deregulation would be expected, all other things equal.

This issue is yet another empirical one for which no data are available. A priori, however, one suspects that deregulation would be followed by greater rent extraction, for the same reasons that deregulation is followed by tax increases. Deregulation, if it occurs, must increase societal wealth. Thus, just as there is more wealth to tax, there is more wealth to threaten and therefore more to be had by rent extraction. The gains from deregulation thus are diminished, reducing the demand for deregulation in the first place.

Conclusion

Although some deregulation has occurred, doubtless achieving economic benefits, the same kinds of benefits are available in other markets that remain regulated. Why the continued regulation? George Stigler reportedly said that there are never seven important reasons for anything. To stay within that limit, the comparative lack of progress in deregulation is ascribed here to just five factors.

First, even if deregulation promises welfare gains on paper, the very fact that regulation already exists creates a presumption that a political equilibrium exists favoring the status quo. There is little reason ex ante to expect changes from that equilibrium in the direction of deregulation to arise or to succeed.

Second, the prevailing model of deregulation is essentially a nirvana model, in that the gains from deregulation can essentially be had without cost. Tullock's transitional-gains trap alerts us that "innocent" purchasers of firms whose previous owners have already benefited from regulation will seek compensation for deregulation. The

22. It goes without saying that "the same kinds of economic interests that influence the setting of economic regulations . . . are also at risk in determining the structure of risk and environmental regulations" (Viscusi, Vernon, and Harrington 1995).

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ongoing heated debate over compensating for costs stranded by deregulation presents perhaps the best example of the trap. There are plausible legal and perhaps even economic reasons why even publicly interested regulators would pay compensation.

Third, those same regulators, once cast as deregulators, might not deregulate in a way that serves the public interest. Once regulation has created the trap, extrication from it requires legal and bureaucratic resolution of competing property-rights claims. But the same (or very similar) legislators and bureaucrats who created the trap are the ones entrusted to effect the extrication from it. Whatever the efficiency argument for stranded-cost remuneration, in the real world of compensation the efficiency argument probably will not dictate the actual outcome.

McCormick, Shughart, and Tollison highlight a fourth disincentive to deregulate: the losses from regulation are sunk and irretrievable. Tullock's seminal insight was that the major losses from regulation take the form of resources expended in rent seeking. But those costs are sunk. To the extent that specialized resources were involved in the rent seeking—resources that could have been devoted to amassing specific capital in producing the regulated good—the deregulated relative price must be higher than the pre-regulation ("competitive") price. Hence, the gains from deregulation are smaller than those indicated by the conventional model of deregulation, which presumes a reestablishment of the pre-regulatory status quo. Indeed, gains may not exist at all, or they may be too small to motivate the political effort necessary to procure deregulation.

Fifth, in the spirit of McCormick, Shughart, and Tollison's model, one appreciates that deregulated industries are not necessarily "competitive" thereafter. Quasi regulation (e.g., taxation) and rent extraction distort markets much as direct regulation does. Excise taxes, for example, raise prices and are applied discriminatorily to limit entry. To the extent that quasi regulation and rent extraction substitute for direct regulation—and there is reason to think they do—the attraction of not being regulated diminishes and less deregulation is demanded.

As many have noted, regulation is much easier to get than to get rid of. The predictable path, once regulation has been adopted, is a series of ratchets upward. The notion that it is easier to regulate than to deregulate is hardly anomalous in the perspective of the overall growth of government power. Other scholars have noted that historically much of the growth of government has occurred in a series of distinct ratchets. War is a particularly powerful upward ratchet. A nation's citizens surrender power to the government easily in the event of war, but find that power hard to recover when the war ends and they want it back (Higgs 1987). Regulation appears to work in the same way.

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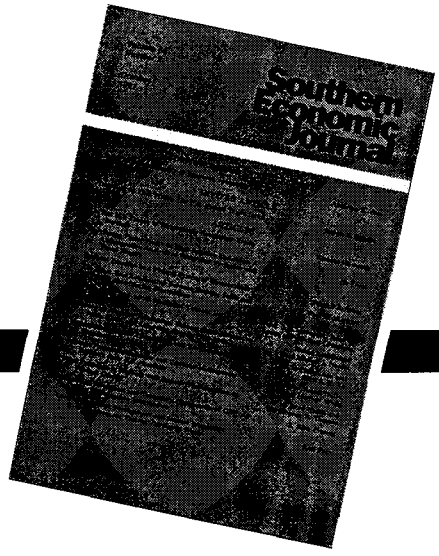

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Fixing the Endangered Species Act

RANDY T. SIMMONS

In a 1934 essay by Aldo Leopold, titled "Conservation Economics" (Flader and Callicott 1991, 193–202), we can find some direction for improving on the command-and-control approach embodied in the Endangered Species Act (ESA) as it stands in 1999. Leopold's insights, as usual, are telling. He began the essay by noting that in his day the accepted theory of the birth of the moon was that a large planet had passed near enough to pull a large piece of the earth into space, creating a new heavenly body. He compared the birth of conservation programs to that process:

> Conservation, I think, was "born" in somewhat the same manner in the year A.D. 1933. A mighty force, consisting of pent-up desires and frustrated dreams of two generations of conservationists, passed near the national money-bags whilst opened wide for post-depression relief. Something large and heavy was lifted off and hurled forth into the galaxy of the alphabets. It is still moving too fast for us to be sure how big it is, or what cosmic forces may rein in its career. . . .
>
> [Conservation's] history in America may be compressed into two sentences: We tried to get conservation by buying land, by subsidizing desirable changes in land use, and by passing restrictive laws. The last method largely failed; the other two have produced some small samples of success.
>
> The "New Deal" expenditures are the natural consequence of this experience. Public ownership or subsidy having given us the only taste of conservation we have ever enjoyed, the public money-bags being open, and private

Randy T. Simmons is a professor of political science and director of the Institute of Political Economy at Utah State University.

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> land being a drug on the market, we have suddenly decided to buy us a real mouthful, if not indeed, a square meal.
>
> Is this good logic? Will we get a square meal? These are the questions of the hour. (Flader and Callicott 1991, 193–194)

These are still the questions of the hour. To extend Leopold's analogy, beginning in 1970 conservation was hurled into a higher orbit with even greater infusions of government cash and regulation. To the "galaxy of the alphabets" were added the EPA, ESA, CIRCLA, RPA/NFMA, and a host of others. The big difference in the years since 1970, as compared to the years from 1933 to 1970, is that government-sponsored conservation rediscovered a new and stronger drug—direct command-and-control regulation, despite Leopolds claim that that method had largely failed. It continues to fail today.

To overcome the failure of endangered-species policy, I propose eight guiding principles, four of them political and four ecological. They are natural extensions of the lessons learned since 1933 and, in fact, reaffirm many of the principles Leopold promoted as he tried to direct the development of a positive political ecology. Adherence to these principles would dramatically alter existing management systems, and the ESA would be replaced with pragmatic, effective, intellectually honest policy.

The biological principles are as follows:

- Preserving habitat is a more important and achievable goal than saving all species.
- Global extinctions are more serious than local extinctions, which are more serious than local population extinctions.
- Preventing ecological wrecks is more feasible and efficient than rescuing them.
- Managing nature protects biological integrity better than does "natural regulation."

The political principles are these:

- Conserving habitat and species requires enlisting private-property owners on the side of conservation.
- Positive incentives are more effective than penalties, if only because penalties are ex post facto.
- Decentralizing biodiversity activities is more effective than centralizing them. That is, twenty competing answers are better than one, especially inasmuch as no one knows which one is right.
- Depoliticizing biodiversity changes incentives for private individuals, public officials, and interest-group representatives and thereby improves the chances of spending funds effectively and creates more private support for conservation.

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The foregoing principles lead away from the idealism and moralism of much of the endangered-species debate and inject pragmatism into the discussion. Although they are consistent with noble goals, they suggest policies that allow for experimentation and creativity.

These principles cannot be adopted under existing endangered-species legislation because they require a more decentralized framework in order to operate effectively. If Congress will allow more decentralization and innovation, if politicians, interest groups, and agency personnel will move beyond what Leopold called "unending insistence on grooves of thought" (Flader and Callicott 1991, 151), then effective policies can be crafted.

Biological Strategies

Include Habitat in the Species Equation

Suzanne Winckler (1992) was correct when she wrote in the *Atlantic Monthly,* "It makes little sense to rescue a handful of near-extinct species. A more effective strategy would focus on protecting ecosystems that support maximum biological diversity" (74). This exhortation goes beyond the obvious point that protecting more habitat is preferable to protecting less. It implies, at least, that before public funds are spent on protecting a particular species an assessment of the appropriate and available habitat should be made. Such an approach would indicate, for example, that it makes sense to spend money to rescue the whooping crane because appropriate and possibly adequate summer and winter habitat exists and within that habitat are the species on which the crane preys. It would *not* make sense, however, to make heroic efforts to save the California condor in the wild, because its habitat requirements are not likely to be met again. Similarly, efforts to singularly protect the lynx or wolverine in the northern Rockies would be judged bad policy inasmuch as those species were historically rare precisely because the habitat is not well suited to them.

This approach is not opposed to the targeted, private actions of organizations such as the Nature Conservancy that purchase small parcels of land in attempts to protect microclimates that are home to species particularly adapted to those microclimates. Those efforts are laudable and possibly important but seem better suited to private rather than public action. Microclimates are vulnerable even to small changes in climate or weather patterns. Limited public funds should be spent where they are most likely to have lasting effects.

Rank Global, Local, and Population Extinctions

The principle of ranking global, local, and population extinctions represents simply a recognition that resources are scarce and that the nation cannot afford to indulge the noble impulse to save every population, every subspecies, or even every species. Policy

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makers must make tough choices, and in doing so they should rank their priorities. Charles Mann and Mark Plummer (1992) quote Gardner Brown, a University of Washington economist, on this issue:

> We can't save every species out there, but we can save a lot of them if we want to, and save them in ways that make sense economically and scientifically. To do that, we have to make some choices about which species we are going to preserve. And nobody wants to do that! Nobody! (66)

Mann and Plummer asked if nobody wanted to make choices "because they are dismayed by the prospect of playing God?" Brown responded, "Oh, sure. But in this case God is just sitting on his hands, which is a pretty dangerous thing for him to do."

As the nation sits on its collective hands, species will continue to disappear at a more rapid rate than necessary, and they will continue to do so as long as the legislative mandate remains "save everything." A much more realistic if less emotionally satisfying rule dictates that policy makers establish priorities and make trade-offs (Easter-Pilcher 1996; Czech and Krausman 1998). In fact, despite the rhetoric about the incalculable value of every species, priorities are being established and trade-offs made under existing policy. The U.S. Fish and Wildlife Service (FWS) has chosen to spend its money on a few species—particularly visible, charismatic ones.

Favor Prevention over Rescue

Almost everyone who writes about endangered-species policy calls for earlier conservation efforts than those adopted under the ESA. Under the current process, populations often fall to nearly irreversible lows before they are nominated for listing as endangered. Immense biological and ecological problems attend the effort to recover a species that is nearly gone. The management problems are also intensified when dealing with a species approaching extinction. Tim Clark, Richard Reading, and Alice Clarke (1994) explain:

> As a species continues to decline and approach extinction, management options narrow, costs rise sharply, and the sense of urgency grows nerve-rackingly high. Fear of failure can become paralyzing; flexibility for experimentation approaches nil. As a result, the context of the recovery program deteriorates into a politically charged and conflict-laden mess with little room for maneuvering. Simply starting conservation *before* a species is severely endangered would alleviate much of the pressure, keep more options open, and reduce the costs. (424–25)

More options at less cost ought to be the motto of species preservation. Choosing such a path would require tough choices, but it makes little sense to spend large sums

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of public money on a species or habitat that is nearly gone if the opportunity cost is to allow other species to slide into a steeper decline.

Manage Nature

In his book about "reinventing nature," William Cronon (1995) explains that "many popular ideas about the environment are premised on the conviction that nature is a stable, holistic, homeostatic community capable of preserving its natural balance more less indefinitely if only humans can avoid 'disturbing it'" (24). This assumption, which he calls "problematic," descends from the work of botanist Frederic Edward Clements, for whom the "landscape is a balance of nature, a steady-state condition maintained so long as every species remains in place" (Barbour 1995, 235).

Central to this belief is the presumption that nature is highly structured, ordered, and regulated, and that disturbed ecosystems will return to their original state once the disturbance is removed. This view of nature is an integral part of successional theory, in which species are seen as replacing one another in an ordered procession, culminating in climax communities. Such thinking continues to animate many modern activists. Bioregionalist Stephanie Mills (1995), for example, writes of "our species beginning finally to take an interest in attending to what the land itself has wanted to bring forth, its creation of self-regulating communities of organisms, climax ecosystems" (3).

Today, however, the "balance of nature" idea is widely rejected by ecologists (Botkin 1990, 1991, 1992; Pielou 1991; Johnson and Mayeux 1992; Pickett, Parker, and Fiedler 1992; DeGraaf and Healy 1993; Tausch, Wigand, and Burkhardt 1993) and by many in the environmental community (Worster 1995; Lewin 1986; Foreman 1995–96).[1] Yet, as ecologist Norman Christensen, dean of Duke University's Nicholas School of the Environment and chair of the Ecological Society of America's panel that reviewed the 1988 Yellowstone National Park fires, argues, "everything from the Endangered Species Act to the Clean Water Act has implicit in it the notion of an equilibrium ecology, the idea that systems tend toward these stable end points and that they are regulated by complex feedbacks—a sort of balance of nature that is almost Aristotelian" (Basgall 1996, 39).

Paradoxically, however, this view is neither modern, progressive, nor scientific. The "balance of nature" idea is in reality an old, conservative, religious view of the natural world that dates to the dawn of written history (Botkin 1990). Instead of constancy and stability, disturbance and change have been the norm throughout the evolutionary history of the earth. Glaciers that covered large portions of North America

1. A 1998 ballot measure in Oregon (Measure no. 64) attempted to codify the balance of nature. If passed it would have outlawed harvesting trees in excess of 30 inches diameter at breast height and would have required leaving at least seventy well-distributed trees per acre harvested. Although some environmentalists opposed such attempts to maintain stasis in forests, the proposal was supported by the Oregon chapter of the Sierra Club, the Native Forest Council, Forest Guardians, and other local environmental groups.

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advanced and retreated repeatedly over the last 3 million years. Not only has the climate fluctuated widely, but what we in the United States view as "normal"—what we have experienced during our lifetimes or since the birth of our nation—is, when viewed in the perspective of the last several hundred thousand years, an abnormally warm, dry period. The longer-run "normal" climate for most of Canada, for instance, is associated with several thousand feet of ice, not with the landscape we see today (Pielou 1991). As one might expect, the distributions of plants and animals have also contracted and expanded over time. Local extinctions are a fact of life, and so is the extinction of entire species. Disturbance and change are the only true constants of ecosystems.

Christensen suggests that the widespread misconception of nature bodes ill for the ESA, which "assumes that we can know what a minimum viable population of a plant or animal is in a very predictable way." He says, "The nonequilibrium approach to ecology suggests that species populations fluctuate constantly. Species may go locally extinct in a given area. They may appear and reappear. That's very frustrating for managers of endangered species and for a public that expects much more deterministic answers from science" (Basgall 1996, 41). The implication is that human beings have a strong role to play in managing the "natural" world. Indeed, current ecological processes have already been structured by human actions, and removing human effects, including fire, will substantially change existing habitats and processes, not necessarily for the better (Budiansky 1995; Kay 1995). Simply setting lands aside as wilderness or preserves and then letting nature take its course will not necessarily save species or protect ecological integrity (Botkin 1990).

Political Strategies

Enlist Property Owners

The single most important step a new Endangered Species Act should take is to remove the power of government agencies to take private property without compensation. Private property rights should get the same protection as the rights to free speech, a free press, or free assembly. Speaking at the Smithsonian Earth Day Conference on Biodiversity, Randal O'Toole (1995) explained the relationship:

> Imagine that freedom of the press meant that the government could censor "only" 20 percent of *U.S. News and World Report* or the *Wall Street Journal.* Or imagine that freedom of assembly meant that the government could forbid "only" 20 percent of all public or private meetings. Anyone would argue that such freedoms would be meaningless under these conditions.

O'Toole then explained that the way in which the U.S. Fish and Wildlife Service sometimes exercises its power under the ESA makes private property rights vacuous.

The intellectual justification for diminishing private property rights rests on an economic argument that the members of the species are not private goods; they are

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public goods, and their public-good nature justifies taking some portion of people's property in attempts to preserve endangered species.

Public goods are those for which provision is nonexclusive and consumption is nonrivalrous. The mainstream economic presumption is that government must provide public goods. Technically, most species are more correctly defined as common-pool resources: their provision is nonexclusive but their consumption is rivalrous. Certain aspects of endangered species are public goods. In fact, each of the most commonly cited justifications for preserving species focuses on their character as public goods: (1) they serve ecological functions; (2) they are sources of knowledge that can be turned to consumptive and nonconsumptive human uses; (3) they are sources of scientific information, models, and theory; (4) all species have rights worthy of respect; and (5) a species-rich world is esthetically superior to a species-poor world. The first three justifications qualify on public-goods grounds—benefits flow to everyone, and no one's consumption of those benefits diminishes anyone else's consumption. The esthetic justification is also a public-good argument to the effect that if we allow species loss to continue, each of us is impoverished, or each person's soul is diminished.

The public-good nature of species may help to explain why opponents of the Fifth-Amendment-takings argument revolt at the proposal that the government compensate the owner when regulations reduce the economic value of private land. They view the landowner as a polluter who should be fined for his actions or stopped altogether. After all, he is reducing an endowment the earth provides to all—and by "all" they mean not just humans but all species. In fact, they argue that the landowners are acting immorally and unfairly. John Humback, a property-rights expert at Pace University, argues, "The whole idea that government needs to pay people not to do bad things is ridiculous. The reason the government exists in the first place is to define what is for the common good and what's not" (Harbrecht 1994, 6).

Secretary of the Interior Bruce Babbitt voiced a similar objection. He was especially concerned that some groups were using takings arguments to resist the protection of endangered species. In a speech, he argued against bills such as House Bill 1388, titled the "Just Compensation Act of 1993." That bill, if enacted, would have required federal agencies to compensate property owners "for any diminution in value" caused by environmental regulations. His response:

> Let's examine the implications of this proposed raid on the public treasury. The Kesterson National Wildlife Refuge in California is one of the great migratory bird stops on the Pacific flyway. But a few years ago, the waterfowl were dying, and they were deformed at birth. It turned out to be selenium poisoning running off into the refuge from nearby farm irrigation wastewater. Under the Endangered Species Act, I tell the farmers: Clean up the pollution or we'll sue you. But under this new proposal, I am undeniably causing a "diminution in value" of a property right—it will cost those

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> farmers money to clean up. They'll comply, but then they'll send me the bill! The old legal maxim, "make the polluter pay," would be replaced by a new legal rule: "It pays to pollute; the government will reimburse your costs." (Babbitt 1994, 55)

Secretary Babbitt's example is important, but his analysis is wrong. His claims are representative of the efforts to mischaracterize property-rights arguments and of a fundamental misunderstanding of the nature of property rights and the proper role of government in protecting them.

As any introductory economics textbook explains, one of the justifications of government action is to prevent one party from harming others and their properties, and, failing that, to punish those who transgress against the rights of others. Controlling pollution has the same justification, namely, preventing the unwanted imposition of wastes or toxins by one party on another. Pollution is a form of "trespass" or "nuisance" under the principles of common law, and those trespassed against can properly call on the power of government to gain restitution.

Babbitt's hypothetical scenario, in which corporations could claim to have been harmed by a prohibition from injecting toxins into the groundwater, does not fit within our tradition of property rights or our system of law. Polluters, being trespassers on others' property, can be stopped; and they are not entitled to compensation. The polluter-pays principle requires that the polluter bear legal responsibility for his actions.[2] In the Kesterson example the story is complicated because the selenium-laden water entering Kesterson arrived in a publicly funded and managed drainage system built by the Bureau of Reclamation. Without that system, the water would never have reached the refuge, so a question remains: Is the polluter the farmers or the bureau?

Still, the principle Secretary Babbitt tried to assert is important. He wants to establish that reducing habitat or harming an endangered species on private property is pollution—an externality landowners are forcing on the rest of the world. Because they are creating costs for others, they should pay to fix the problem. If proponents of that approach can make the externality or pollution argument stick, they will prevail over the constitutional takings argument. If polluters ought to pay ***and*** if reducing the habitat of endangered species constitutes pollution, then landowners must pay.

But Secretary Babbitt's logic is flawed for at least two reasons. First, biodiversity is a slippery concept. It may be true that once the earth dips below a certain level of biodiversity, it is a poorer place biologically, but until we reach that threshold, the marginal loss of species has little effect on our store of biological "wealth." This claim applies with particular force when species are defined so narrowly that distinct subpopulations are treated as if they were single species. Saving every species and every

2. The polluter-pays principle pertains to one of the major economic concerns of environmentalism—negative externalities. Negative externalities are costs of one person's actions that are passed on to others without their consent (e.g., water pollution from pesticide residues).

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population of each species, no matter how biologically insignificant, makes no biological or economic sense. It requires an enormous stretch of the imagination, for example, to suppose that the extinction of the Bruneau Hot Springs snail or the Colorado humpbacked chub would impoverish their former habitats or diminish biodiversity in any scientifically significant way.

This insignificance argument should not be pushed too far, however. Many tiny reductions in biodiversity can and sometimes do add up to significant reductions in biodiversity, just as many nonpoint sources of pollution can add up to serious pollution problems. Such is the essence of the tragedy-of-the-commons argument: each individual loss is insignificant, but all of them together amount to a tragedy. So, although saving every species is a silly goal, consciously sacrificing a species or a population is not necessarily trivial.

Reevaluating the nature of the situation provides a second and better reason why the public-goods and polluter-pays arguments are wrongly applied to private producers of species habitat. Humanity[3] may "own" the rights to biodiversity, but landowners own the habitat that individual members of species occupy. Thus, the landowners are being asked to produce a public benefit upon which all of humanity can free-ride. In the case of Kesterson or other examples of pollution, the landowners ought to bear responsibility for the costs they impose on others. In the case of biodiversity, the landowners are producing a *benefit*, and if members of society value the biodiversity the landowners produce, ways should be found to encourage the landowners to continue to produce that positive externality.

The difference here is between public costs (negative externalities) and public benefits (positive externalities). The pollution-producing landowner passes *costs* on to others who have not contracted to bear them. The biodiversity-producing landowner passes *benefits* on to others who have not contracted to receive them. The policy responses should differ: punish those who create costs but reward those who create benefits. Notice, however, that the ESA punishes those who produce benefits—a perverse policy indeed!

The polluter-pays principle has been misapplied in endangered-species policy. The assumption has been that owners who wish to develop their land are "polluters" of the species found on that land and must be either stopped from undertaking activities that would "pollute" the species or made to pay for any effects their actions have on the species. California property owners who are being denied permission to create firebreaks on their property or to build additions to their homes without paying mitigation fines exemplify the issues involved. Landowners required to stop timber harvest on nearly 30 percent of their property provide another example.

3. The logic does not change if we accept the anti-"humanist" argument that "ownership" is broader than just humanity and should include all species.

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But what if property rights were recognized so that the owners' use of their property could not be curtailed without compensation even if a listed species resided on the property? Then, in effect the landowners would own the species on their property even though the title to the species still rested nominally with the state. The species could then be treated as private goods rather than common-pool goods, and those who wished to protect or save the species would operate within markets as opposed to the political realm as they do now. No longer treated as polluters, property owners would be treated as producers of something of value to others.

Defenders of Wildlife is already using such methods to protect wolves, because they consider hearing wolves howling again in Montana to be a public good for which they are willing take responsibility (Anderson 1994). Ranchers, however, view wolves as polluters: wolves kill an occasional cow, calf, or sheep and thereby impose uncompensated costs. Solving wolf "pollution" problems under the polluter-pays principle requires that the polluter be identified and fined. In this case, Defenders of Wildlife claims responsibility and stands willing to pay. But instead of calling the payment a fine, they call it a reward.

In the spring of 1994, a rancher near August, Montana, collected a $5,000 reward from Defenders for having three wolf pups successfully raised on his property. In anticipation of the reward, the rancher followed advice from state and federal biologists about how to minimize human disturbance, and he managed to leave the wolves alone. A rancher's usual response to wolves on his property is to "shoot, shovel, and shut up," because wolves threaten to impose costs. In this case, Defenders of Wildlife paid the costs.

Defenders have been paying the costs of wolves since 1987, when they created a Wolf Compensation Fund to pay for livestock killed by wolves. So far, the Fund has paid $12,000 to about a dozen ranchers. One problem of this approach is that the landowner cannot decide the price of the tolls. Another is that, although Defenders' compensation-insurance program may cover the costs of a replacement cow, it does not pay the rancher for the time spent proving the cow was killed by wolves, arranging for the replacement cow, or organizing transportation. Clearly the system is not perfect, but no system is. And because the ranchers' normal means of excluding wolves is to quietly kill them, a system that compensates for use—employing the user-pays principle—increases the chances of Defenders' members being able to hear wild wolves howl again. By adding a reward for allowing wolves to use one's land, Defenders of Wildlife have turned the liability of being the provider of a public good into an asset and turned ranchers' incentives in a new direction. What is more, the payments are relatively small and are paid by private parties, not out of the public treasury.

Another organization pursuing the same kinds of innovative policies is the Delta Waterfowl Foundation, a private nonprofit organization dedicated to reversing the downward trend in North American duck populations by stopping the loss of habitat. The foundation conducts research and provides education and economic incentives to

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farmers. It is supported from tax-deductible contributions.

One of the foundation's programs is Adopt-a-Pothole. Funds are raised from contributors all over North America, each of whom receives an aerial photograph of the adopted pothole, a quarterly report on its status, and an annual estimate of duck production. The farmer receives $7 per acre to maintain pothole habitat and $30 per acre to restore pothole habitat. In addition, farmers are offered production contracts that pay based on the actual numbers of ducks produced. The production contracts encourage farmers to improve and protect nesting habitat.

Results have been impressive. After just two years of operation, contributions totaled nearly $1 million from more than a thousand individuals and organizations, and eighteen thousand pothole sites were enrolled. Nest density is twice as great for adopted sites as for unadopted sites, and nesting success averages 51 percent for adopted sites, compared to 10 to 15 percent for unadopted ones. The program has even developed a special nesting box that protects birds from predators, and potholes using the device have nesting success rates of 90 percent (Delta Waterfowl 1994).

An important difference exists between the Defenders of Wildlife wolf program and the Delta Waterfowl program. The wolf is listed under the ESA, so ranchers who attract it to their property run the risk of having the uses of their property regulated by the FWS. None of the mallards, canvasbacks, shovelers, blue-winged teal, green-winged teal, gadwalls, redheads, or pintails that nest in the prairie potholes are endangered. Farmers know they can attract the ducks without having to worry that the value of their property will be reduced because they protect and develop duck habitat. Thus, they are pleased to be paid to attract ducks by improving habitat and changing farming practices. They win and the ducks win. If the threat of ESA regulations were removed from wolves, western ranchers would be more interested in attracting them than they are now.

Employ Positive Incentives

The importance of understanding and using incentives may seem obvious. Yet Congress and the implementing agencies ignore the incentives their laws and rules create. Randal O'Toole (1995) argues that our existing laws and most proposals to change them "are based on the same assumptions upon which the Soviet Union based its entire economy—assumptions that people will do what they are told or follow some moral principle even if their incentives run in the opposite direction" (1). A large public-choice literature (Mitchell and Simmons 1994) shows that not only do citizens respond to perverse incentives; bureaucrats do, too. Policy makers must carefully consider, therefore, the incentives a new Endangered Species Act will create, or they will be disappointed by its consequences.

A host of private individuals and groups such as Defenders of Wildlife and Delta Waterfowl are using positive incentives to promote species and habitat preservation.

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They provide private benefits to landowners who produce a public good. Many other opportunities exist to let the species pay their own way; and many endangered species can pay their own way if allowed to do so. South Africa, for example, decided that private entrepreneurs were the best agents to save several species of endangered vultures—birds as big as California condors. Tourists who wish to view and photograph these endangered raptors pay to see them at "vulture restaurants," where carrion is provided for the birds. Local Boy Scouts gain service hours by hammering carrion bones into fragments small enough for the birds to swallow. The bone fragments are a necessary source of protein and were once broken up by hyenas, which are now extinct in the vulture's breeding range (Reiger 1993, 14).

In the United States, a broad range of ventures, from exotic game ranches in Texas to greenhouses producing cacti for the supermarket trade, allow species to pay their own way. In 1979 the FWS revised its regulations to allow commercial foreign trade in American alligators. Alligator farming has become so successful that wild populations have exploded, and universities in the South now offer courses in alligator farming. One entrepreneur received permission to raise alligators in a warm-springs area in southern Idaho, a location far outside the alligator's normal range. He expects to feed them dead cows from nearby dairy farms, thereby solving a difficult disposal problem for the farmers and gaining a free source of food for his alligators.

The Costa Rican government allows rain forests to pay their way by means of the discovery and patenting of genetic resources. It is often argued that great human benefits will accrue from species we have not yet even studied. One congressional report asked, "Who knows, or can say what potential cures for cancer and other scourges, present or future, may lie locked up in the structures of plants which may yet be undiscovered, much less analyzed?" However, in most countries natural genetic resources cannot be patented, and so private companies have little incentive to prospect for them. Costa Rica's formal response to this problem was to allow the Instituto Nacional de Biodiversidad (INBio) to contract with pharmaceutical companies to prospect for and develop indigenous genetic resources. In the first agreement, Merck, Inc., a major international firm, agreed to make an initial payment of $1 million over two years. In addition, the company will make a royalty payment to INBio from commercial sales of products developed (Sedjo and Simpson 1995, 175). Considering that one-quarter of today's cancer drugs derive from random testing of organisms, the potential for significant royalties is clear.

In speaking of "letting species pay," I emphasize *letting*. Many environmentalists are appalled by commercialization of wildlife, especially endangered species. They strongly oppose letting the species pay their own way. The U.S. Fish and Wildlife Service, for example, in 1983 rejected a proposal to allow commercial use of captive-bred green sea turtles. The current controversy over the private Grizzly Discovery Center in West Yellowstone, Montana, is another example. The owner wanted to create a park where the viewing public could see grizzly bears. He proposed stocking the

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park with nuisance bears from Yellowstone and other parks. The alternative is to kill the bears, as the Park Service does routinely. But the Park Service would not allow him to have any of its nuisance bears. One member of the Greater Yellowstone Coalition, a local environmental group, was quoted in *Newsweek* as saying that she would rather see the bears killed than put into the "artificial" habitat of the private park. She refuses to let the bears pay.

Roger Beattie, a New Zealand conservationist, tells of a similar conversation with an official from the Mount Bruce Endangered Species Unit. The official took Beattie on a tour of the complex, describing each endangered species and its management. When they came to a species of kakariki, the official explained that the female birds were in one aviary and the males in another. Beattie (1994) asked why, prompting the following exchange:

> OFFICIAL: We do not want them to breed any more.
> ROGER: Do you mean to say that you have birds in an endangered species unit that you are deliberately not breeding?
> OFFICIAL: Yes.
> ROGER: Why?
> OFFICIAL: We do not know what to do with the extra young birds.
> ROGER: Have you thought of selling them?
> OFFICIAL: Oh no! You couldn't do that! (6)

Selling the extra young birds would let the birds pay at least part of the costs of their preservation. That approach has worked well for alligators, provides income from the Costa Rican rain forest, and protects South African vultures. It should be used more widely.

Attitudes toward letting the species pay may be changing, and the change may be hastened just by rewording the slogan. Instead of saying "let the species pay," we can say "make the users pay." Thus, the polluter-pays principle can be evoked to protect habitat. Mill Creek Canyon, east of Salt Lake City, Utah, is an example. This publicly owned canyon was frequently visited but received just $3,000 per year from the Forest Service to be managed for human use. Salt Lake County built a toll booth just outside the canyon and now collects a modest toll from all who enter. The money is given to the local Forest Service Office under condition that it be spent on the canyon. The toll booth is now generating more than $125,000 per year to be spent on riparian restoration, control and disposal of human and pet waste, and protection of the canyon's fragile watershed (Smart 1994).

The same approach can be used in other areas of critical habitat, but politicians must resist the temptation to dictate how the fees are spent; otherwise they will restrict the managers' entrepreneurial capacities. An ongoing study at the Political Economy Research Center in Bozeman, Montana, is finding that for state parks, restrictions on the spending of fee income reduce creativity and even the incentive to collect the fees (Leal and Fretwell 1997).

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Decentralize Conservation

Environmentalists tend to push for centralized policies. If a preferred solution is imposed nationally, lobbyists do not have to deal with fifty state legislatures and the local interest groups of each state. Some issues do require a national policy. Some species, such as the Colorado squawfish, cross state boundaries and require attention from a regional if not a national body. But most endangered-species problems are local.

Decentralization can entail turning responsibility for endangered species over to states, but it can also allow private groups and individuals, as well as local, state, and national officials, to participate in protecting endangered species. Some private groups will help species without compensation, and governments should allow them to do so. One model is the restoration of the peregrine falcon, an accomplishment of Dr. Tom Cade of Cornell University and the Peregrine Fund. Using techniques developed by falconers over centuries, they raised birds in captivity and then released them into the wild. The birds nested in very surprising places—on bridges into New York and other cities and on urban skyscrapers. One-way glass and television monitors have been installed so people can watch the falcons nest, raise their young, and devour pigeons. Today more pairs of peregrine falcons are nesting in New Jersey than at any other time for which records exist.

The wood duck provides another example. Early in this century people expected it to follow the passenger pigeon and the Carolina parakeet into extinction because its wetland habitat and the dead trees in which it nested were disappearing. But a massive, national, voluntary campaign to build and place artificial nesting boxes reversed the trend. The wood duck is now the second most common duck species in North America, and wildlife agencies are encouraging hunters to take more of them and fewer of other species (Seasholes 1995, 8). Imagine Audubon Society members, Boy Scouts, hunters, and other interested citizens—the same groups that organized to save the wood duck—approaching owners of timberlands and asking permission to put up spotted-owl nesting boxes today. Very few would give permission. Had the ESA been in place when the wood duck was endangered, few landowners would have been willing to allow the nesting boxes on their property, and the wood duck, in all likelihood, would now be extinct.

Electric companies attract bald eagles to their property because of the wetlands and ponds created by their cooling operations and because the fenced, patrolled property keeps people from disturbing the birds. But under the ESA, companies become financially responsible for any eagles they inadvertently attract. The ESA does allow the issuance of incidental-take permits that absolve the companies of some responsibility, but the process for getting the permits is cumbersome and expensive. If the rules were changed to allow the FWS and private organizations to act as Delta Waterfowl officials do, electric companies might behave very differently. Instead of inadvertently attracting eagles, they might actively encourage them. Think of the difference it could

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make if, rather than being fined when a young eagle on its first flight was killed by flying into power lines, the company were rewarded whenever a young eagle migrated from its property. Consider, too, the many other species that could benefit from a company's actions to protect an endangered species and its habitat.

Some people enjoy creating preserves on their property and will bear substantial expense to protect species there. Roger Beattie and his wife created a preserve on their New Zealand farm. One block of the farm contains a stand of native forest that is home to several native bird species as well as nonnative predators. They fenced 20 hectares of that forest as a nature preserve, erecting a six-foot-high predator-proof fence, a combination of deer, rabbit, and bird netting and electric wiring. Inside the fence, they spent two months setting bait stations and traps to rid the preserve of rats, stoats, cats, and dogs. Their goal was to reintroduce the eastern buff weka, a rare bird species, onto the preserve. This species is no longer found in Canterbury but was introduced on the Chathams during the last century and flourishes there. Getting the permits to transport and release the weka on the reserve took longer than eradicating the predators, but in April 1994 the birds were released. Beattie said,

> Conservationists have spent much time and effort deliberating over how they would reintroduce the weka to Canterbury. We just set out and did it. . . . The success of our private reserve shows there is a better option for nature conservation than preying on taxpayers. That success comes from immediate and effective action. (1994, 7)

The Beatties plan to capitalize on their success by selling information, assistance, and services to other predator-proof nature preserves.

Private groups can also involve themselves in preserving species if they are allowed to bid for uses of public land just as they now bid for private land. On private land, you may buy timber and let it stand, pay for a grazing right and leave the grass for wildlife, or hold a mineral right but leave the underground minerals undisturbed. If the same system were applied to public lands, anyone could bid on commodity sales and then use the land for conservation purposes instead of extraction. Allowing public land managers to make such sales would introduce a new dynamic to public lands management, because private parties could preserve habitat they consider significant. One can even envision private groups purchasing conservation easements to public lands.

Some environmental groups already have purchased rights to lands they consider important. In 1998 a coalition of five environmental groups in the Pacific Northwest purchased the equivalent of a conservation easement in Loomis State Forest in north-central Washington. They purchased the logging rights to 24,000 acres, the only roadless area in the 2-million-acre forest. The Loomis is a high-elevation lodge-pole pine forest that harbors grizzlies, fishers, and Canadian lynx. Washington's Common School Trust, which uses the income from timber harvest for the state's public school system, manages the Loomis. The purchasers will pay the trust what it would have received had the

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site been logged and pay for an additional harvestable tract elsewhere in the state. In 1996, the Forest Guardians of New Mexico outbid a rancher for a 644-acre degraded, riparian-area grazing lease. Instead of managing for cattle, they managed for wildlife by planting willows and other vegetation, and they removed the livestock (Brown and Shaw 1998).

An Idaho environmentalist, Jon Marvel, attempted to purchase grazing leases on state lands in Idaho. He believes the state lands are overgrazed and hopes to lease the lands and exclude cattle. So far he has failed because, although he outbid the ranchers, the ranchers convinced the Idaho Land Board to reject his bid. The 1995 Idaho legislature even passed a law to make it very difficult for a nonrancher to bid on state grazing lands. But Marvel has taken his case to the Idaho Supreme Court and expects to win. He points to an Oklahoma case in which the court, relying on trust language in the state constitution, ruled that the state could not offer leases to ranchers at below-market rates. Expired Oklahoma leases are now advertised on television (Stuebner 1995).

Land leases for a variety of nontraditional uses should soon become prevalent. Once the political power of traditional users is broken through court decisions or by increased public attention, whole new patterns of endangered-species protection will emerge, including easements and purchases. Under such arrangements, groups that currently oppose grazing might even use it as a management option to benefit endangered species. Many private and public wildlife refuges graze cattle, for example, to manage the vegetation. Domestic livestock are not necessarily harmful (Kay and Walker 1997). What is harmful is a system of political management that suppresses creativity and adaptation.

Depoliticize Biodiversity

Enlisting property owners, providing positive incentives, and decentralizing biodiversity protection cannot be accomplished until the process is depoliticized. In part because of the need to generate continued political support for endangered-species protection, the FWS spends most of its money on charismatic species (Dwyer, Murphy, and Ehrlich 1995, 738–39). In addition, managers pursue strategies that make little ecological sense but a lot of political sense. The core of a strategy to depoliticize the process pertains to the budget. Simply put, the FWS must pay its own way.

For that to happen, the funding mechanism for endangered-species protection must be changed. Currently, the FWS receives a budget from Congress, but in reality it has a virtually unlimited budget because it can list species and thereby control private landowners' actions without having to pay the costs associated with the listing. If, however, the FWS could not "take" property without compensation, it would have to make tough choices, especially if it had a fixed budget.

Insisting that the FWS make tough choices does not imply that biodiversity would be less protected, but rather that the mix of policies would change and that managers

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would have incentives to innovate. As Richard Stroup, an economist at the Political Economy Research Center, points out in public lectures about the ESA, bureaucrats must make choices in order to spur the search for alternative policies. He notes how aluminum-can manufacturers reduced the amount of aluminum in each can by more than 60 percent as they sought to use the metal more efficiently. He suggests that bureaucrats would search for the same kinds of efficiencies if they were given a mandate to maximize biological integrity with a fixed budget.

One proposal is to create a biodiversity trust fund that collects a fixed share of public-land user fees each year (O'Toole 1995, 3). A user fee of $6 per day would generate about $4.6 billion per year in addition to the commodity user fees of roughly $3.4 billion. A biodiversity trust fund that received just 10 percent of those fees would have $800 million, a great deal more than the 1994 FWS endangered-species appropriation of $6.7 million (Corn 1995, 8). Another possible funding source was suggested by a former Department of the Interior economist, who proposed earmarking a portion of royalty and bonus payments from the development of oil reserves on the Arctic National Wildlife Reserve (Nelson 1995, 122).

Having a trust fund charged with promoting biodiversity and funded from user fees would relieve many of the political pressures that now drive endangered-species policy. Funding determined as a percentage of user fees would replace funding determined by congressional whim and interest-group politics. Because the trust's income would come from fees for the use of federal lands, the trustees would have an incentive to make sure the federal land agencies charged market value for the consumptive and nonconsumptive resources located there. The trustees would also have a vested interest in providing information to Congress when resources were being provided at less than their value. O'Toole suggests having the biodiversity trust fund managed by a board of trustees made up of conservation biologists or ecologists appointed by cabinet officials such as the secretaries of agriculture and interior or the director of the Smithsonian Institution and serving nine-year terms (1995, 2). The model is the federal reserve boards. Expenditures from the trust fund would have to be justified to the trustees, who could also accept proposals from state agencies and private groups for protecting biodiversity. Competition for funds would spur innovation and creativity. Proposals to spend millions to restore wolves to Yellowstone, for example, would have to compete with proposals to spend the same amount of money to protect a host of truly endangered species across the nation.

Trustees might discover that it makes sense to allow many species into markets where owners would have an incentive to protect them. Fee hunting, farming, and captive breeding are all market activities that require relatively small funds to oversee and monitor. Because many species cannot be adequately protected in markets, however, to protect those species the trustees would have to consider a range of positive incentives, from awards or other forms of recognition to cash awards to rental of

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habitat. Like Delta Waterfowl, the innovative conservation officer might pay for output (e.g., hatchlings per pothole) rather than simply setting aside habitat.

Where no such policies can work, it would make sense to rent or purchase habitat. Even then, however, buying easements rather than land might prove sufficient. Landowners might be invited to enroll their lands in a program that required them to manage those properties in a particular way. In return, they would receive payments or other forms of compensation. Such a program resembles the "conservation reserve" or "wetlands reserve" programs of the federal government, in that landowners enrolling lands in those programs commit themselves to certain land management practices and receive payments. For bureaucrats with fixed budgets and a broad range of possibilities for preserving habitat, a better approach would be to tie compensation to actual increase in numbers or the attraction of particular species rather than to the simple adoption of certain management practices.

The underlying dynamic is that agency personnel or trust fund officers would have a mandate and a fixed budget. Required to carry out the mandate and subject to their budget, they would have a strong incentive to innovate and to rank choices about which species to concentrate on and which policies would best meet the conservation objectives. They would have to ask whether a particular species or habitat can be protected most efficiently if treated as a private, a public, or a toll good. Thus, endangered-species policy would become dynamic, innovative, and purposeful.

A simple way to depoliticize conservation is to establish conservation rental contracts (CRCs). Renting most habitat would be far cheaper than purchasing it and could be customized to meet the needs of the species and the landowner. Thomas Bourland and Richard Stroup (1996), the originators of the CRC concept, suggest that rental contracts are especially important in the southeastern United States, where about two-thirds of the commercial forest belongs to private owners. Attempting to put together large-scale programs under that ownership pattern is difficult, but targeted rental efforts could operate successfully.

CRCs could be used for spotted owls and desert tortoises. Every X years a census could be taken to determine how many owls or tortoises lived on someone's land, and a payment made to reward the owner for having maintained the population. An additional reward might be offered for having attracted new owls or turtles. In this way, the owls and turtles become quasi-private property of the landowners. The endangered species generate income rather than expenses. By protecting the species and their habitat, the landowners make themselves better off. Such a system could work for a broad range of animal and plant species.

If endangered-species proponents had to produce rewards for landowners instead of legislation penalizing landowners, new political dynamics would emerge. Federal agents calling on landowners in Utah's Garfield and Iron counties, which harbor Utah prairie dogs, would receive the same welcome as a realtor. Both the agent and the realtor would have something positive to offer the landowner and, because they

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would not be limited by the strict rules of the ESA, they could in many cases work out arrangements that benefited everyone.

It is impossible to estimate how much money is "needed" to protect endangered species. In fact, need statements make little sense apart from the question, "at what price?" Given scarce resources, we must recognize that, although all species may be important, some are more important than others. If inexpensive ways are found to protect species, more will be protected. Decentralizing species protection into the many systems we have suggested provides ways to discover efficiencies and thereby to protect more species. But until the endangered-species budget is fixed and the power to shift costs to others is removed from the FWS, the search for innovation and efficiencies will be stifled.

Stop Subsidizing Ecosystem Disruption on Private Lands

As part of a move to depoliticize and decentralize conservation, federal and state subsidies to private landowners must be ended. Leopold wrote of laws and programs that "frequently clash, or at best, fail to dovetail with each other" (Flader and Callicott 1991, 199). Today we see subsidies for private lands that certainly do not mesh with endangered-species protection and often work against it (Losos et al. 1995). The Washington, D.C., promoters of those programs seldom see how they encourage development on fragile lands that would otherwise never be economically feasible. O'Toole (1995) claims that "subsidies are the biggest threats to rare species on both public and private land. They include everything from below-cost timber sales to animal damage control programs to import tariffs on sugar that encourage sugar production near the Everglades" (10). Loan guarantees and loans below market rates of interest have serious ecological consequences. A major conference center was built in a canyon near my home using loans subsidized by the nation's taxpayers. The development might eventually have occurred without the loans, but they were a factor in its happening when it did. Similarly, federal crop insurance, flood insurance, and disaster relief all contribute to overdevelopment of private lands.

Floods in the Midwest and coastal fires in California are particularly important examples. Given the propensity of rivers to flood, private bankers are not likely to grant loans for building on a floodplain unless the loan applicant has federal flood insurance that assures the banker the federal government will cover the bank's losses in case of flooding. Thus, federal disaster relief creates an additional incentive to build on the floodplain. The rules of the game in California's dry hills are much the same. The homebuilder is told, in effect, "Build in areas that have a history of fires, and if the fires come the state and federal governments will provide disaster relief as well as firefighters and equipment at no additional cost to you."

Ending those subsidies will not stop the disruption of all remaining habitats, but it will stop some of them, because developers, farmers, and homeowners will have to

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bear more of the costs of their own actions. It is no secret that as individuals are made less responsible for their actions—that is, required to pay less of the cost—their behavior becomes more reckless. Removing subsidies reduces the recklessness.

Stop Subsidizing Ecosystem Disruption on Public Lands

A better name for the public lands is "the political lands." Their use is determined not by what people want but by what the organized interests want. These political lands contain many habitats for endangered species, because federal and state governments own more than a third of the onshore land in the United States. Subsidized private users, however, unnecessarily disrupt those habitats. More than half of Forest Service timber sales are below-cost sales. The recreation subsidy is even worse in terms of the dollars lost to the treasury; most recreation opportunities are simply given away. As Terry Anderson suggested in a telephone conversation, "If environmentalists were serious about having the federal government stop giving away resources, alongside their 'Cattle Free in '93' bumper stickers they would have had 'Hike No More in '94.'"

As with subsidies to private landowners, subsidies to consumptive and nonconsumptive uses of the public lands encourage overuse and reckless use. Doing away with those subsidies is a major political problem; it will not be solved by simply outlawing them. Instead, structural changes need to be made to the agencies that administer the lands. Depoliticizing the political lands poses a daunting challenge. For examples of market-oriented approaches, see *Reforming the Forest Service,* by Randal O'Toole (1988), and *Public Lands and Private Rights: The Failure of Scientific Management,* by Robert H. Nelson (1995).

Move away from Coercive Incentives

Analysts who recognize the value of incentives but prefer to have them handled more by government than by markets propose policies based on what they call "market incentives" but are more properly termed "coercive incentives." These incentives are innovative and appear to be more effective at protecting biodiversity than is the ESA. But they rest on different premises than the ones I suggest. I begin with the premise that landowners actually own their land and that public and private organizations that want particular biological outputs of that land should pay for them. Coercive incentives start with the premise that property rights are vested in government, which grants use rights to private parties. For example, Larry McKinney (1993) proposes the following set of policy tools, which contains a mix of positive and market incentives:

- Property tax credits for habitat maintenance
- Tax credits for habitat improvements

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- Partial tax credits for ESA compliance expenditures
- Income-tax deductions for farm lands managed to support endangered species
- Tax penalties for habitat conversion
- Prohibition on the use of federal subsidies and tax benefits for activities causing habitat loss or degradation
- Creating a market for development rights on important biological habitat

He offers the following caveat:

> The opportunity costs of not extracting marketable resources or converting land to commercial or residential uses can be substantial. These tax incentives do not seek to bridge the considerable distance between status quo, land-based revenues, and unrealized opportunity costs. They are intended as motivating incentives and economic signals, *not* as compensation for the effects of lawful and appropriate government regulation. (McKinney 1993, 4)

His proposals are less expensive for landowners than the absolute taking that occurs under the ESA, but McKinney emphasizes that he does not propose to offer full compensation. Landowners are "granted" development rights that are insufficient to develop their own property. In effect, this "grant" of development rights is actually a reduction of the owners' rights to develop their property. In order to develop, they must purchase development rights from other landowners. Thus, landowners, developers, and customers bear the financial burden of conservation on the property. They are forced to privately fund public and common-pool goods.

One example is the system of tradable development rights (TDRs) implemented in Montgomery County, Maryland, and the New Jersey Pinelands. In each case, trading development rights in one area in order to exceed density restrictions in another has preserved open space. In Maryland thousands of TDRs have been transferred, and in the New Jersey Pinelands 10,000 acres have been protected (Goldstein and Heintz 1994, 53).

Elizabeth Kennedy, Ralph Costa, and Webb Smathers (1996) suggest a similar mechanism they call "marketable Transferable Endangered Species Certificates (TESC)" for red-cockaded woodpeckers. They model their proposal on TDRs and pollution-rights certificates and suggest limiting the TESCs to landowners within a statewide habitat conservation plan. Landowners who wanted to alter habitat on their property could purchase TESCs from other landowners or by translocating juvenile birds from their property to protected properties. Those who owned certificates would be allowed to alter habitat in ways normally not allowed under the ESA. The price of TESCs would be determined by the costs of engaging in more costly mitigation or management practices. The authors note that under their proposal, "Costs (i.e., the cost of accumulating or purchasing the necessary number of certificates) would be

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more than those for forestry operations without the ESA obligation, but landowners could potentially cut timber sooner, decreasing opportunity costs" (Kennedy, Costa, and Smathers 1996, 25). They cite estimates of current opportunity costs on highly stocked stands that range from $143 to $1,486 per acre (23).

Again, notice that the costs of all these proposals fall on the landowners. Nor do the TDRs, TESCs, and tax credits require agency personnel to rank conservation priorities, make careful choices, or search for innovation.

Conclusion

People will try to conserve species if doing so serves their interest. Unfortunately, many of the people whose involvement is critical to saving species and habitat do not find preservation in their interest. Public and private land managers pursue private agendas, which may or may not be in the public interest, depending on the costs and benefits they face in that pursuit. Thus, National Park Service personnel with a vested interest in a paradigm they helped to develop justify their actions regardless of what the data tell them. Agents of the Fish and Wildlife Service, anxious to retain or increase their congressional funding, spend most of the endangered-species budget on charismatic species such as wolves and grizzly bears while they do little to aid truly endangered species with less emotional appeal. Organized interests use elephants to raise money and promote Western eco-imperialism, even though their actions reduce incentives for those who live among the elephants to protect them. Private timber owners accelerate harvesting if they fear that their land harbors endangered red-cockaded woodpeckers. Alternatively, they may cut down trees with holes in them, cut them into sections, and dispose of the section with the hole. All cavity nesters lose, including other species of woodpeckers, flickers, screech owls, and flying squirrels.

Positive incentives would cause owners, land users, activists, and policy makers to recognize the costs of their actions and would bring human management to the fore. Adopting the proposals presented here would produce a multitude of approaches to habitat and species preservation instead of the limited, prescriptive policies imposed by the ESA. Specifically, government can

- Let species pay their own way by allowing private groups and individuals to profit from protecting species and by allowing public agencies to charge user fees.
- Decentralize biodiversity protection efforts to states and private organizations. Many competing answers are better than one, especially inasmuch as no one knows what the right answer is.
- Depoliticize the protection process by creating a biodiversity trust fund that would change incentives for private individuals, public officials, and interest-group representatives and thereby improve the chances of spending funds effectively while creating private support for conservation.

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- Stop subsidizing ecosystem disruption on private lands to reduce development on fragile lands.
- Charge user fees on public lands so that users bear some of the costs of preservation as well as paying the costs of their own actions.

Adopting these proposals will not save all species or keep people from making mistakes. They will result in actions that rely on trial and error, learning from mistakes, and using that new knowledge to respond to new challenges and problems. This approach is, therefore, emphatically not advanced as a set of "solutions." I do not know what solutions are best. I believe, however, that the most effective policies would allow resilience and flexibility in a dynamic, changing world. My approach will allow society to harness the creativity of people everywhere to innovate, experiment, take new risks, and produce new knowledge; it is, in fact, adaptive management (Walters 1986). Such a process would produce responses that no one can predict. Just as those who predicted timber shortages could not foresee chipboard and particle board or the technology that turned previously worthless trees into usable building materials, thereby creating timber surpluses, we cannot foresee the exact responses to many of the present—and certainly not the future—species controversies. The best we hope for is that policy makers will set in motion processes that allow innovation and experimentation to produce those responses. Aldo Leopold summarized this argument well in the conclusion of his essay "Conservation Economics":

> This paper forecasts that conservation will ultimately boil down to rewarding the private landowner who conserves the public interest. It asserts the new premise that if he fails to do so, his neighbors must ultimately pay the bill. It pleads that our jurists and economists anticipate the need for workable vehicles to carry that reward. It challenges the efficacy of single-track laws, and the economy of buying wrecks instead of preventing them. It advances all these things, not with any illusion that they are truth, but out of a profound conviction that the public is at last ready to do something about the land problem, and that we are offering it twenty competing answers instead of one. Perhaps the cerebration induced by a blanket challenge may still enable us to grasp our opportunity. (Flader and Callicott 1991, 202)

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The Political Economics of Campaign Finance

JEFFREY MILYO

The public debate over campaign-finance reform is often framed as necessitating an unfortunate tradeoff between the liberal ideals of free speech and association on one side and the democratic ideals of equal representation and participation on the other. But despite frequent calls for dramatic action, the terms of the tradeoff are not well-understood. In this regard as in others, the study of the political economics of campaign finance is more notable for its faults and oversights than for its contributions. Scholarly work on campaign finance provides little basis for a cost-benefit analysis of proposed campaign-finance reforms.

First, no one has analyzed systematically the effects of campaign-finance regulations on freedom of speech or association. Are such regulations enforced in an even-handed or a haphazard manner? Are they enforced at all? How do campaign-finance regulations affect the nature of citizen participation and public debate? Are corporate, labor, and other interest groups equally constrained? Are organized interest groups less hampered by regulation than more ad hoc coalitions? It is difficult to evaluate the desirability of either current laws or proposed reforms when the potential costs of various policies have been completely ignored by scholars and policy makers alike.

Second, we do not know much about the supposed benefits of campaign-finance regulations. Despite a plethora of research on how money affects either electoral or policy outcomes, the quality of those studies is often wanting. Recently, important methodological advances have been made in the empirical analysis of the electoral consequences of campaign spending, although no strong consensus has been reached on the importance of money in elections (e.g., Grier 1989; Levitt 1994; Ansolabehere

Jeffrey Milyo is an assistant professor in the economics department at Tufts University.

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and Snyder 1996b; Erickson and Palfrey 1998; Gerber 1998; Milyo 1998a). In addition, several admirable empirical studies of campaign contributions focus on the allocation of funds by political action committees (PACs) to congressional incumbents (e.g., Snyder 1990, 1992 and 1993; Grier and Munger 1991a, 1991b; Grier, Munger, and Roberts 1994). Though not unimportant, PAC contributions represent a small and declining share of total campaign contributions—down to about 15 percent of all contributions to federal candidates in 1996. Further, no consensus exists in the research literature as to whether campaign contributions are the functional equivalent of bribes (Lowenstein 1996; Milyo 1998b). Finally, several relevant insights from the theory of social choice have not been applied to the question of how campaign finance affects the democratic process.

In this article I deal primarily with the last two questions: Are campaign contributions interested, and if so, should we care? I argue that contrary to the apocalyptic rhetoric of some reformers, interested money plays a less deleterious role in American politics than is commonly held.

The Conventional Wisdom

The corrupting influence of money in politics is a staple of media pundits, public-interest advocates, and even many politicians. The basic claim is that interested money perverts the democratic process in three ways: (1) campaign contributions buy legislative favors, (2) campaign expenditures buy elective office, and (3) popular disgust with the dominant role of money in politics causes ordinary citizens to withdraw from participation in the political process. Consequently, the current system of campaign finance is thought to undermine the twin democratic principles of representation and participation.

It is not difficult to find lurid examples and descriptive statistics consistent with the claim that money is the driving force in American politics (Stern 1991, 1992; Morris and Gamache 1994; Makinson and Goldstein 1996). For example, usually in electoral contests the candidate who spends more money wins. Further, when incumbent officeholders run for reelection, they usually spend far more than their challengers, and they usually win reelection easily. Also, PAC contributions flow disproportionately to incumbents, and those incumbents often vote in ways that please the sponsors of their donor PACs. The funding advantage of incumbents is compounded because the absence of serious competition permits many incumbents to build up large stockpiles of unspent campaign funds. To the extent that those war chests deter future challengers, the incumbents become more securely entrenched in office. Finally, turnout in elections has been generally decreasing and campaign spending generally increasing. Yet, notwithstanding the foregoing familiar facts, more systematic evidence and more sophisticated analysis tend not to corroborate the conventional wisdom.

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Empirical Studies of Campaign Finance

The conventional wisdom on the role of money in politics stands in disturbing contrast to the findings of most academic research on the topic (to the great frustration of those of us doing the research). In short, most academic experts would agree that it is very difficult to find consistent and convincing evidence that interested money buys either elections or policy favors (e.g., Sorauf 1992; Levitt 1995).

One important implication of recent empirical research on campaign finance is that the marginal value of a campaign contribution is quite small, both to the recipient and to the donor, because current law limits the size and source of contributions and because marginal campaign spending appears to have little effect on electoral outcomes (Levitt 1994; Milyo 1998a). Corroborating evidence comes from studies that demonstrate that neither candidate wealth nor campaign war chests deter challengers (Ansolabehere and Snyder 1996a; Milyo and Groseclose 1998). Therefore, it is not surprising that there is little evidence that PAC contributions influence the roll-call voting behavior of legislators (e.g., Bronars and Lott 1998; Levitt 1998).

These findings are consistent with the fact that relatively little money flows into political campaigns. For example, aggregate contributions to federal candidates and parties during the 1995–1996 electoral cycle totaled just over $2 billion (Miller 1997). This amount is equivalent to about 0.02 percent of GDP, or roughly one-third of the amount contributed to the United Way during the same period. Note that Americans donated over $300 billion to charitable causes during that period, and corporations alone gave more than $15 billion. Further, case studies of major corporations suggest that the funds spent on charitable activities by major firms are about ten times greater than the combined total amount devoted to political activities by those firms, their associated PACs and their employees (Milyo 1998b). If campaign contributions were the functional equivalent of bribes, we might expect much more money to flow into political campaigns. Consequently, most political contributions should be considered relatively *uninterested* money.

Soft Money

An important distinction must be made between campaign contributions to candidates and PACs, which are limited by the Federal Election Campaign Act, and those to parties or issue-advocacy campaigns, which are not currently limited. Money raised in accordance with federal contribution laws is known as "hard money"; such contributions may be spent on any type of political advertisement. "Soft money" includes any donation to a party or other group that does not qualify, by either amount or source, as hard money. Soft money may be used for generic issue-advocacy advertisements but not for advertisements that explicitly advocate voting for or against a particular candidate. Of course, the generic issue-advocacy activities are sometimes close substitutes

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for campaign advertisements. Further, soft money contributions to the state and national political parties allow those parties to transfer more hard money to candidates (Dwyre 1996). Consequently, soft money contributions have been the target of numerous recent reform efforts.

Soft money contributions are more likely to be effective "bribes" than are direct campaign contributions to individual legislators, because soft money contributions are unlimited in amount and because political parties have various methods of disciplining their members and delivering political favors. Nevertheless, soft money contributions to the two major national parties amounted to less than $275 million during the 1995–1996 electoral cycle, equivalent to 15 percent of the hard money spent during that period. Further, 93 percent of all soft money was raised in amounts of less than $20,000 (www.fec.gov).

It is difficult to reconcile the relative dearth of soft money with the notion that such contributions constitute effective bribes. But it is consistent with the claim that most hard money contributions are uninterested and that the sheer volume of those contributions drives the marginal value of campaign contributions down so far that interested money has little incremental value to politicians. Thus, so little interested money flows into politics because it does not buy much legislative action. However, an important caveat must be made here: no one knows how much money is spent on generic issue-advocacy campaigns or more subtle attempts to manipulate popular opinion (e.g., the content of popular entertainment programming). Consequently, it is difficult to assess the degree to which interested money affects American politics through this soft money "loophole." Nevertheless, we have good reason to doubt the popular understanding of the role of money in politics.

Moreover, even if interested money does play an important role in American politics, it does not follow that the basic principles of democracy are being ill-served, because interested money also has some salutary effects on majoritarian politics.

Lessons from the Theory of Social Choice

The most significant conclusion of social choice theorists in the last half century is that no collective decision rule can always satisfy a certain reasonable set of "rationality" conditions (Arrow 1963). Further, given a collective of heterogeneous individuals, several different methods can be used to aggregate their individual preferences into a collective preference, each method being arguably consistent with the democratic ideals of representation and participation, but those methods produce different collective choices (e.g., Riker 1982).

In light of the foregoing conclusions, it is not obviously undesirable for interested money to produce deviations from what would otherwise occur under simple majority rule. After all, pure majority rule is irrational, inasmuch as a pure majority-rule equilibrium almost never exists (Plott 1967). Worse yet, under majority rule,

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agenda setters wield extreme influence over outcomes (McKelvey 1976). Finally, in large elections voters have little reason to vote responsibly (Brennan and Lomasky 1993). It is therefore not unreasonable to view interested money as a check on the power of political agenda setters or the whims of a less interested and temporary majority (Hayek 1960).

What Is Democracy?

In common parlance, democracy has come to mean simple majority rule. Institutions that hinder action by simple legislative majorities, whether they be internal to the legislature (the filibuster, the committee system, party leadership, supermajority rules) or external (executive vetoes, judicial overrides)—are often decried as undemocratic. In this perspective, outside pressure from special interests in the form of lobbying or campaigning is undemocratic because it may change the legislature's choice. However, deviations from simple majoritarianism are widely accepted, even strongly preferred, in certain venues. For example, supermajority rules are used for altering the Constitution and for jury decisions, although plurality rule is used to decide the outcomes of most elections. Clearly, the frequent equation of democracy and simple majority rule in common parlance signals imprecise language and intellectual laziness more than it evinces a popular consensus for such a narrow understanding of democratic decision making.

A more sensible definition would denote as democratic any institutions that limit the inevitable inequalities of representation and participation to some tolerable level. Of course, having accepted such a definition, one cannot draw a bright line between democratic and undemocratic institutions. Consequently, once we adopt a more expansive understanding of democracy, it becomes more difficult to maintain that the presence of interested money in politics is necessarily undesirable.

Control of the Legislative Agenda

The intransitivity of pure majority rule is more than just a theoretical curiosity. The inherently chaotic tendencies of pure majority rule lead legislatures to adopt rules of procedure that constrain legislative choice and empower agenda setters. Procedural rules typically limit the feasible set available to the legislature, dictate the order of consideration of the feasible options, and restrict the mechanism of choice to a series of binary (yea, nay) votes. The ability to manipulate the content and ordering of the legislative agenda permits party leaders to wield significant influence over the outcomes of legislative choice (Cox and McCubbins 1993). However, free and open public debate can focus the attention of the electorate and raise the cost of agenda manipulation.

For example, issues such as campaign-finance reform, term limits, and balanced-budget restrictions are typically far less popular among legislators than among the

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general public. Party leaders often block such issues from even coming up for debate. However, in many instances, special-interest groups have successfully raised public awareness of and concern about these issues and forced them onto the legislative agenda. Thus, allowing interested persons to lobby their representatives and fellow citizens reduces the power of agenda setters. At the same time, participants in the public debate come to consider new information and arguments. Of course, some misinformation and illogic will also be injected. But it is hardly self-evident that the social costs of issue advocacy and lobbying outweigh their social benefits.

Representation of Intense Interests

Even if we ignore the pervasiveness of intransitivity, pure majoritarian institutions are deeply flawed on normative grounds. Simple majority rule is the most direct implementation of the principle of "one person, one vote," and although this principle is held in great esteem, its appeal stems partly from the implicit assumption that all persons have an equal stake in the collective outcome. That is clearly not the case in what we might call "private" matters; indeed, a generic right to privacy is so well accepted that few Americans would find that the existing constitutional guarantees of their individual liberties are "undemocratic." The great flaw in majoritarian institutions is that each individual's preference is weighted equally, even though individuals differ enormously in the intensity of their preferences.

Supermajority requirements are one common method of accounting for the intensity of individual preferences. Such rules permit the votes of an intensely concerned minority to outweigh those of a less concerned majority. However, such rules may also permit an unconcerned minority to thwart the desire of an intensely concerned but insufficiently large majority.

A second method of incorporating intensity of preferences in the collective choice process is to give disproportionate weight to the preferences of intense minorities. The committee system in Congress can be viewed as an attempt to do so: preference outliers seek membership on committees with narrow policy jurisdictions, and the rules of the House and (to a lesser extent) the Senate permit committee members disproportionate influence over legislation in their jurisdiction (Weingast and Marshall 1988).

A third method of incorporating the intensity of interests is simply to permit deliberation and debate. By communicating their positions, intensely interested persons can better inform the collective about any disproportionate effects of a policy or, at least, appeal to the magnanimity of the less intensely interested. Because not all interests will be well represented in a given legislature and because effective persuasion may be quite costly, groups will naturally form around common interests and pool their resources for the purpose of influencing the decisions of the legislature or the opinions of citizens at large. Consequently, special-interest lobbying and issue-advo-

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cacy activities serve a socially desirable function: they permit at least some minority interests to inform the collective about the intensity of their preferences.

A final method of incorporating information on the intensity of individual preferences into the collective choice process is vote trading. Within legislatures, such exchanges are known as log-rolls. Being voluntary, these vote trades necessarily work to the expected advantage of the interests entering into them. Further, in majoritarian institutions, vote trading necessarily involves minority interests, as otherwise the majority would simply pass its preferred legislation directly. Consequently, through log-rolling, minority interests improve their lot by "buying" legislation dear to them at the cost of supporting legislation relatively unimportant to them (but dear to some other minority interest). In this way, majoritarian institutions become more responsive to minority interests.

An indirect form of vote trading occurs through campaigning and elections. Intense interests provide support to candidates in exchange for political favors. However, candidates who cater only to special interests risk alienating large segments of the electorate. Consequently, candidates must expend resources to inform and persuade the electorate. Thus, candidates serve as arbiters, both between competing groups of intense special interests and between intense special interests and the unconcerned majority. If the interests of minority groups are sufficiently intense, then those groups will provide enough support to candidates that the candidates can then afford to ignore the interest of the majority on the issue in question. Of course, it is easy to envision contexts in which such an outcome is normatively either appealing or appalling, but the same is also true of pure majoritarianism.

Voter Participation

Rational-choice theories of voter participation posit that individuals weigh the benefits of voting against the costs. The benefits of voting consist of the satisfaction of the act itself and the expected change in the outcome of the election that results from one vote. The costs of voting include the time and effort required to actually cast a ballot; for example, registering to vote, becoming informed about candidate positions, finding the appropriate polling place, and queuing to vote. It is widely appreciated that in large elections the probability that a single vote will be decisive is essentially nil, so the decision to vote turns on a simple weighing of the intrinsic value of the act against its costs.

It is often claimed that public disgust with campaign finance helps to account for declining voter participation. The main evidence for this claim is the fact that campaign spending and turnout have been moving roughly in opposite directions over the last fifteen years. This observation is consistent with the claim, but it is scarcely convincing evidence of a causal relationship.

Does campaign spending cause voter apathy by lowering the intrinsic value of voting? If so, we might expect that individuals with more cynical views on campaign

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finance, party politics, and government would be less likely to vote. A recent poll of voters and nonvoters commissioned by the League of Women Voters suggests that is not the case: nonvoters hold views very similar to those of voters (www.lwv.org/lwus/mellsumm.html). The major difference found between voters and nonvoters is that the latter have a higher opportunity cost of time and are less likely to feel strongly that they have a duty to vote. This evidence is consistent with the rational-choice theory of voting but gives no support to the claim that the prevalence of interested money in politics reduces voter participation.

It may be, however, that interested money depresses turnout in a more indirect fashion. Because interested money flows primarily to incumbent officeholders, the dramatic increase of campaign spending may have reduced the competitiveness of elections and thereby lowered turnout. But this argument has two serious flaws.

First, as I have shown elsewhere (Milyo 1997), congressional elections have actually become more competitive as campaign spending has jumped. Despite an increase of real incumbent spending and no change in the proportion of experienced challengers, House races have become closer, incumbents have drawn down their war chests, defeats have increased, and the proportion of unopposed incumbents has dropped. The increased competition for partisan control of Congress is surely one of the primary causes of the upward trend of aggregate campaign spending. Further, the failure of increased competitiveness to cause a similar increase in the voter-participation trend is consistent with the view that the instrumental value of voting does not drive an individual's decision to vote.

The second flaw in the logic is the presumption that electoral competitiveness would raise turnout in large-electorate contests. It is true that empirical studies of elections repeatedly find that turnout is significantly correlated with the closeness of the electoral race. It is also true that many rational-choice theorists have interpreted this finding as evidence consistent with the rational-choice theory of voting, the idea being that an individual's vote is more likely to be decisive in a close race. However, in large elections, the probability of casting a decisive vote, even in a close election, remains negligible. Consequently, changes in the expected closeness of an election should not have a significant and direct effect on turnout.

The observed correlation between turnout and closeness is not evidence of a proximate causal relationship. Rather, greater electoral competition causes increased spending, which in turn causes increased turnout. Electoral competitiveness raises campaign spending for two reasons. First, the expected closeness of the election increases the propensity of donors to give to candidates and causes candidates to expend more effort on raising funds. Second, because campaign spending is used largely for campaign advertisements, voter interest is peaked in districts bombarded with numerous advertisements. In fact, voter turnout is significantly related to campaign spending even when controlling for the closeness of the race (Milyo 1998c).

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In sum, there is little support in either theory or empirical analysis for the claim that the presence of interested money in American elections has caused the general decline in voter turnout.

Conclusion

Participants in the public debate over campaign-finance reform have generally assumed that interested money corrupts democratic politics. However, recent empirical studies indicate that interested money does not play an extremely influential role in federal elections. More importantly, the theory of social choice informs us that the net effect of interested money on the democratic ideals of representation and participation is ambiguous. My appraisal places a greater burden on reformers: a cost-benefit analysis of campaign-finance reform must consider not only the real costs of regulation on free speech and association; it must also demonstrate a net positive effect on democratic procedure.

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EX9

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Privatization of Public-Sector Pensions

The U.S. Navy Pension Fund, 1800–1842

ROBERT L. CLARK, LEE A. CRAIG, AND JACK W. WILSON

Recent projections indicate that expenditures on Social Security retirement benefits will begin to exceed payroll-tax revenues and trust-fund earnings before the year 2020, and the Old Age, Survivors, and Disability Insurance (OASDI) trust fund will be depleted within roughly ten years of that date. If substantial changes are not made in the Social Security system, then expenditures are projected to exceed revenues by more than 5 percent of the payroll covered by the Social Security tax. Numerous analysts, commissions, business groups, and labor organizations have studied this situation and made recommendations for changes in the system. One proposal is for changes in the investment strategy of the OASDI trust fund. Presently, tax receipts beyond current outlays are placed into the trust fund, which is permitted to invest only in special-issue U.S. Treasury "bonds," which are essentially accounting entries in the budget of the U.S. government. Many reformers favor some type of private investment of Social Security funds. Proposals include (1) retaining the current structure of Social Security benefits but investing part of the existing trust fund in private equities and bonds, (2) establishing small individual accounts that would

Robert L. Clark, Lee A. Craig, and **Jack W. Wilson** are faculty members in the College of Management at North Carolina State University.

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be centrally managed with some or all of the funds being invested in private securities, and (3) directing most of an individual's Social Security taxes into private accounts that would have a wide range of private investment opportunities.

Proponents of investing Social Security funds in private securities point to the higher expected returns compared to current investment practices. If the funds were invested in the equity or liabilities of private corporations and if they earned returns similar to the average returns over the past fifty years, then Social Security recipients could enjoy greater retirement benefits at the same cost, or the same benefits with a lower tax burden, or some combination of the two. Depending on the proposal and the investment strategy, such a change in investment practice could partially alleviate the system's long-run financing problems.

Opponents of investing a portion of Social Security funds in private assets highlight the greater risk associated with private securities relative to federal debt. Those risks include greater variation in year-to-year returns, possibilities of large capital losses, and the risk of fraud and malfeasance in the management of the funds specifically and in financial markets more generally. Inevitably, with private investments some retirees may have lower pension benefits than they would have had if all funds had been invested in government bonds, whereas other retirees will have higher benefits.

The debate over permitting the Social Security trust fund to invest in private securities has proceeded without reference to past U.S. experience with the investment of public pension funds in private securities. Indeed, our review of the literature suggests that participants in this debate have assumed, either implicitly or explicitly, that federal pension funds have never been invested in private assets. But they have been. In the first half of the nineteenth century, a substantial proportion of the assets in the U.S. Navy pension fund were used to purchase equity in private companies.

Although the modern Social Security system dwarfs the nineteenth-century navy pension fund in both size and scope, the issues involved in the coverage and funding of the benefits reflect many of the same concerns facing the Social Security system today, and the history of the navy pension fund provides a case study of the potential problems associated with the investment of public pension funds in private equities. Among those problems are the government's inability to credibly shift the risks associated with privatization to those insured by the fund and the government's tendency to increase the benefits as the fund grows.[1] In the case of the naval pension fund the bankruptcy of private firms whose equity composed a substantial proportion of the fund's portfolio ultimately led to taxpayer-funded bailouts. Also, Congress

1. In this article we use the term "privatization" synonymously with "investing in the equity or liabilities of private corporations." Although this meaning is not always what people have in mind when using the term privatization, we believe the gains from concision outweigh any resulting confusion.

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substantially extended the benefits in response to an existing surplus in the pension fund, an action that ultimately resulted in its insolvency. This history has relevance to current debates about the privatization of Social Security.[2]

The Navy Pension Fund

During the earliest years of the republic, Congress decided to provide disability pensions for naval personnel. Although today the term *pension* is associated with retirement, the navy pension fund was essentially a disability fund.[3] From 1790 through 1797, these pensions were paid to naval (and army) personnel from general appropriations. Legislation enacted in July 1797 provided that officers, marines, and seamen injured in the line of duty were entitled to a disability pension. In the case of officers, the pension was not to exceed half pay, and the benefit for marines and seamen was not to exceed $5 a month. In both cases, the benefit depended on the extent of the disability (Seybert [1818] 1969). Additional legislation enacted in 1798, 1799, and 1800 established a separate pension fund for naval personnel, providing a disability benefit with a maximum of half pay for marines and seamen as well as officers. That fund was ultimately to be financed by the sale of prizes, either ships of war or merchantmen of belligerent states or neutral merchantmen carrying contraband.

The laws establishing the navy pension fund also prescribed the fund's administrative structure, its management, and the eligibility conditions for receipt of benefits.[4] The fund was placed under the management of the secretaries of the Navy, Treasury, and War Departments. The 1799 legislation stated that the commissioners of the pension fund should invest all funds in "six percent or other stock [bonds] of the United States, as a majority of them, from time to time, shall determine to be most advantageous." However, the 1800 legislation authorized the commissioners to invest the fund's monies "in any manner which a majority of them might deem most advantageous" (Seybert [1818] 1969, 692). The commissioners of the fund took advantage of their broad charge in 1809 by purchasing a large number of shares

2. Another concern, not considered here, is the risk that because of the government's tendency to respond to political rather than market forces the value of the firms in which the government owns a stake could be driven below their free-market value. On the other hand, the government might employ its powers to artificially drive up the value of firms in which it has a stake at the expense of potential competitors and perhaps taxpayers.

3. American Express established the first formal employer-provided pension plan in the United States in 1875, and by the turn of the century a handful of private companies, mainly railroads, had added such plans (Latimer 1932). Although a few municipalities provided pensions to police officers, firefighters, and teachers, the first plan for state employees was established by Massachusetts in 1911, and the federal civil-service pension plan was created in 1920 (Craig 1995).

4. The 1800 legislation, designated an "Act for the Better Government of the Navy of the United States," specified that the commissioners of the pension fund must provide annual reports to Congress on the operations of the fund. Those reports provide information on the activities of the pension fund and are the primary source of data employed in this article.

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in a local bank, the Bank of Columbia. Later they invested in two other local banks, Union Bank and Washington Bank. Prior to these purchases of shares, all investments of the fund had been in U.S. bonds. Although the fund's revenue increased during the War of 1812 due to the availability of prizes, the Bank of Columbia failed in 1823–24, causing a loss of income and a temporary loss of capital at a time of increasing obligations to pay benefits. As the pension fund grew, the commissioners found it increasingly difficult to manage through three federal departments. Eventually they requested that Congress place the fund under a single department, and in 1832 the secretary of the navy was made the fund's sole manager. At that time Congress mandated that the Treasurer of the United States hold all fund assets in custody, and directed the secretary of the navy to invest all pension funds in stock of the Bank of the United States (Glasson 1918, 102). The reorganization of the fund's management arose from problems associated with the investment in the Bank of Columbia (about which we say more later).

The 1800 act also provided that "every officer, seaman and marine, disabled in the line of his duty, shall be entitled to receive for life, or during his disability, a pension from the United States, according to the nature and degree of his disability, not exceeding one-half of his monthly pay" (*American State Papers,* Naval Affairs, vol. 4, report no. 529, Jan. 17, 1834, 487).[5] In order to receive a disability pension, a person had to complete an application indicating the circumstances of the injury, when it occurred, the extent of the injury, and the extent of the resulting disability. The application had to be signed by the company surgeon and commanding officer. Injuries could result in a partial or total disability, and the amount of the pension depended on the extent of the disability. Pensions were forfeited if the veteran was convicted of a felony (*American State Papers,* Naval Affairs, vol. 4, report no. 524, Dec. 23, 1833, 427).

Table 1 lists the value of the interest- and dividend-earning assets of the navy pension fund, the annual returns on its portfolio, the number of beneficiaries, the total amount of annual benefits paid, and the average benefit per recipient for each year between 1800 and 1842.[6] The figures show that the number of beneficiaries, the total cost associated with their pensions, and per capita expenditures generally increased during the life of the fund. The number of pensioners increased from 22 in 1801, receiving annual benefits of $1,605 ($72.95 per recipient), to 946 beneficiaries at an annual cost of $107,129 in 1842 ($113.24 per recipient for "ordinary" benefits and $232.60 per recipient including "extraordinary" payments).[7]

5. In June 1812, Congress created a similar fund for privateers. The fund, to be supervised by the secretary of the navy, would receive 2 percent of all U.S. prize money. It was depleted in 1837.

6. Through 1836 these data are from the various annual reports by the commissioners of the navy pension fund; thereafter, they are from the annual reports of the secretary of the navy, which were required by Congress.

7. The estimates of extraordinary payments are largely back benefits as required by subsequent legislation (described later).

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Table 1: Estimated Annual Navy Pension Fund: Amount Invested, Investment Returns, Number of Pensioners, and Annual Outlays of the Fund Paid to Pensioners, 1800–1842

Year	Fund[a,b] Investment (dollars)	Annual Returns (dollars)	Number of Pensioners	Annual Outlays (dollars)	Per Capita Outlays (dollars)	
					Ordinary	Extraordinary[d]
1800	26,552	489	-	-	-	-
1801	56,556	4,748	22	1,605	72.95	-
1802	79,056	5,485	-	-	-	-
1803	126,325	8,457	37	3,567	96.40	-
1804	129,712	9,147	37	3,261	88.13	-
1805	164,595	10,478	49	4,413	90.06	-
1806	165,963	13,364	65	5,298	81.51	-
1807	177,344	14,206	78	6,396	82.00	-
1808	175,460	14,407	85	6,863	80.74	-
1809	220,397	11,341	90	6,671	74.12	-
1810	192,809	14,821	93	7,043	75.73	-
1811	206,076	15,967	107	8,045	75.19	-
1812	210,701	17,204	122	9,287	76.12	-
1813	206,076	10,896	148	11,273	76.17	-
1814	484,852	31,392	176	13,667	77.65	-
1815	598,557	39,255	252	20,547	81.54	-
1816	594,041	32,589	327	27,627	84.49	-
1817	724,950	52,153	358	32,036	89.49	-
1818	877,236	57,221	-	34,970	-	-
1819	874,672	57,739	438	39,340	89.82	-
1820	870,862	52,330	480	43,863	91.38	-
1821	891,895	53,338	491	44,488	90.61	-
1822	906,662	52,654	431	38,772	89.96	-
1823	910,515	49,016	423	37,248	88.06	-
1824	819,436	46,340	524	-	-	-
1825	900,166	49,606	524	-	-	-
1826	917,902	47,482	533	49,653	93.16	-
1827	911,252	47,519	534	-	-	-
1828	642,633	40,569	570	-	-	-
1829	950,675	36,204	596	-	-	-
1830	967,081	42,406	536	31,938	59.58	-
1831	1,003,880	34,476	536	-	-	-

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Year	Fund[a,b] Investment (dollars)	Annual Returns (dollars)	Number of Pensioners	Annual Outlays (dollars)	Per Capita Outlays (dollars)	
					Ordinary	Extraordinary[d]
1832	937,047	37,465	-	-	-	-
1833	947,545	52,443	-	-	-	-
1834	1,142,462	50,000[c]	-	-	-	-
1835	1,160,162	50,000[c]	442	54,083	122.36	-
1836	1,143,639	50,886	466	58,009	124.48	-
1837	1,049,232	-	678	87,768	129.45	296.00
1838	390,832	-	847	103,120	121.74	255.06
1839	253,139	-	901	110,123	122.22	247.55
1840	158,739	-	914	108,750	118.98	242.53
1841	23,600	-	959	113,903	118.77	236.52
1842	-	-	946	107,129	113.24	232.61

[a]Excludes cash holdings; therefore annual returns less outlays do not equal the change in the value of the fund's assets.

[b]Holdings vary according to whether the assets are valued at cost or in terms of par. It is not always clear which definition is being used.

[c]Authors' estimates.

[d]The figures in this column were derived by equating the two extraordinary Treasury remittances, which appear to have been passed "straight through" a cash position to beneficiaries, with the extraordinary claims for back benefits resulting from the act of 1837.

Source: Authors' calculations based on information in the tables and data of Clark, Craig, and Wilson (1998) and original sources cited therein.

Although the long-run trends of pensioners and benefits were upward, legislation regulating the fund tended to expand coverage, benefits, or both when the fund expanded, regardless of its actuarial condition.[8] For example, in 1813, benefits were extended to the widows of navy personnel who died from wounds received in the line of duty. Those benefits, equal to half the monthly pay of the deceased, were to be paid for a five-year term. Payments could be renewed for additional terms of five years each. If no surviving widow existed, these survivors' benefits could be paid to children under sixteen years of age. In April 1816, the commissioners were authorized to provide benefits in excess of half pay in cases of hardship.[9] The extension of benefits to widows and orphans, along with the growth of naval personnel during the War of 1812, dra-

8. On the rent-seeking advantage of small, well-defined groups, see Olson (1965, 53–65). The success of federal workers in such activities is detailed in Johnson and Libecap (1994, 126–48). For a survey of empirical studies documenting this phenomenon for public-sector workers in general, see Mueller 1989, and on federal pensions in particular, see Craig 1995.

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matically increased the payment of pensions. In 1816, payments of $27,627 went to 327 veterans, widows, and orphans. In 1817, benefits to widows and orphans were expanded to include those whose husband or father had died "*in consequence* of disease contracted or of casualties or injuries received" (emphasis added). If a veteran's dependents could show that his death was somehow connected to his previous service, then they would be eligible for benefits. The extension sharply increased expenditures, and by 1823 pensions totaling $37,248 were being paid to 423 beneficiaries. In 1824 that provision was repealed. Persons already receiving benefits were allowed to continue receiving payments; however, the act stipulated that no future pensions would be awarded to widows. Despite this change, the total number of beneficiaries continued to increase, reaching 596 in 1829, and the fund continued to grow, reaching $950,675 in the same year.[10]

With the fund approaching $1 million and the number of pensioners stabilizing in the early 1830s, Congress could not resist the temptation to expand the coverage of the pension plan. In June 1834, in response to the growth of the fund, Congress restored the provisions for widow-and-orphan benefits that had been in effect between 1817 and 1824. The *American State Papers* made the case that the fund had sufficient resources to cover the expansion of benefits, though given the lack of new monies resulting from prizes and the aging of the veterans of the War of 1812, it would have been difficult to support such a claim with plausible actuarial scenarios (*American State Papers,* Naval Affairs, vol. 4, report no. 529, Jan. 17, 1834, 489). The legislation provided for the extension of benefits to widows of officers, seamen, and marines who had died since 1824. That extension of benefits resulted in "a heavy charge [being] made upon the fund" (*American State Papers,* Naval Affairs, vol. 4, report no. 616, Mar. 21, 1836, 863). The number of widows granted a pension benefit under the terms of all previous acts totaled fifty-six, but the new legislation added eighty widows to the rolls at an annual sum of $20,031, an amount equal to nearly 40 percent of the whole of navy pensions (*American State Papers,* Naval Affairs, vol. 4, report no. 616, Mar. 21, 1836, 863).

In November 1835, the fund had assets of $1,160,262, and the income for 1835 was $66,083. Expenses totaled $23,842 paid to 306 disabled veterans and $30,241 paid to 136 widows and orphans. In assessing the implications of the 1834 legislation,

9. In the annual report filed in January 1816, the commissioners concluded that limiting the benefit to half pay "proved inadequate to the maintenance of disabled seamen and marines, particularly the latter, which cannot exceed three dollars per month. The extension of the law, so as to vest in the commissioners a discretionary power to allow, in extreme cases, to the full amount of monthly pay, or otherwise to provide for the necessary subsistence of those who are totally unable to take care of themselves, would, it is believed, obviate causes of complaint, and reflect honor upon the liberality and justice of the National Legislature" (*American State Papers,* Naval Affairs, vol. 1, report no. 134, Jan. 9, 1816, 381).

10. Note that the figures in column 1 of table 1 include only interest- or dividend-earning assets. The cash holdings of the fund are unavailable; thus, for example, the dip in the fund's value in 1828 appears to be simply the result of a temporary increase in the fund's cash position.

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the commissioners, who were also the trustees of the fund, lamented Congress's improvident expansion of benefits:

> It will be perceived that, by the act of 1834, a pension is allowed to the widow of every person who may die in the naval service by reason of disease contracted while in his line of duty; a phrase than which nothing can be more vague or more liable to abuse, and which is nearly tantamount to authorizing a pension to be granted to the widow of every person who may die in the naval service. To such an extension of the pension system, the committee are decidedly opposed. (*American State Papers,* Naval Affairs, vol. 4, report no. 616, Mar. 21, 1836, 863)

By March 1837, despite the recent increase of claimants and outlays, the fund had increased to $1,115,330, and interest and dividends exceeded $50,000. Disregarding future claims that would ultimately arise as the War of 1812 veterans died, Congress once again expanded benefits, approving the "Act for the More Equitable Administration of the Navy Pension Fund" (the Jarvis Act). The legislation required the fund to pay pensions to widows and orphans from the dates of the veteran's death. In addition, it stipulated that pensions granted to veterans be paid from the time they were disabled, thereby creating substantial liabilities because of the previous nonpayment of such benefits.

Perhaps not coincidentally, the passage of the act was simultaneous with a 50 percent increase of naval personnel between 1836 and 1837 (U.S. Bureau of the Census 1975, 1142). That expansion was planned during the peak of the business cycle, and Stanley Lebergott's wage series for "able-bodied seamen" shows a peak in 1836 (Lebergott 1964, 530); so it may well have been the case that Congress was simply increasing the total compensation of naval personnel in order to recruit new seamen. If that was so, the panic and subsequent recession of 1837, which began two months after the act was passed, ultimately made it unnecessary (Thorp 1926).

In any case, the commissioners of the pension fund opposed the Jarvis Act. The payment of back pension benefits ran as high as $6,000 to $8,000—roughly 5 to 9 percent of the total annual outlay at that time. The annual number of pensioners increased to 847, and annual expenditures to $103,120. "Arrears payments soon consumed nearly $600,000. Between March 3, 1837, and October 1, 1838, about $725,000 of the invested capital of the fund was sold, and the proceeds, with the interest and dividend on the capital were applied to payment of pensions and arrears" (Glasson 1918, 104). Note that the figures in columns 4 and 5 of table 1 do not include those extraordinary expenditures for back claims; however, the inclusion of such payments (in column 6) more than doubled the per capita outlays after 1837.

The sharp reduction of the pension fund reduced annual income while the increased number of beneficiaries sharply increased expenditures, resulting in the fund's further decline. Complaining about the pressures Congress had put on the fund, the

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secretary of the navy reported that the act of 1837 "has decreased [the fund] with increasing celerity, a large portion of the pensions granted in conformity with its provisions involving arrearage commencing many years anterior to its passage." Primarily, this development arose from the first section of the act, which provided that pensions to widows and orphans "shall be paid from the date of the demise of the husband or fathers. The only condition is, that the demise shall have happened in the naval service." The secretary concluded that

> arrearage of pensions for more than thirty-seven years, in one instance involving the payment of more than $20,000, have been paid under this section which has mainly caused the rapid diminution of a fund originally constituted for the sole purpose of providing for officers and seamen only, disabled in naval service.[11]

Following the passage of the Jarvis Act, the fund declined in two years from $1,115,330 to $253,139. Concluding that "the primary source of the decline of the navy pension fund is the act of 1837," the secretary went on to note:

> It is therefore certain that at the end of two years, at the farthest, the navy pension fund will be exhausted. Under the existing laws there is not the least prospect of any decrease in the number of pensioners or the amount of their pensions; and consequently, Congress will be called upon to . . . make good any deficiency in the navy pension fund arising out of its own legislation. (U.S. Senate 1839)

And that is exactly what happened.

With the pension fund facing total liquidation, Congress passed new legislation in August 1841 appropriating $139,666 to provide for the continued payment of pensions to current beneficiaries until the close of the next session of Congress. Benefits would not be paid to the widows and orphans of men who died after the passage of that act. In 1842, Congress appropriated another $84,951 and formally repealed the act of 1837. In 1843, Congress began the practice of authorizing the payment of two years of benefits from general tax revenues (Glasson 1918, 103).

The history of the legislation pertaining to the navy pension fund shows that Congress, after yielding to the temptation to expand the fund's coverage beyond its actuarial capacity to support those covered, ultimately shifted the liability to taxpayers. The fund's performance also reflected the other risk we mentioned in our introduction, that associated with holding equity or the liabilities of private firms. To that aspect of the navy pension fund we turn next.

11. The 1839 report of the secretary of the navy also noted that the second section of the act of 1837 contributed to increased expenditures from the fund. "The section of the same act provides, that 'pensions which have been granted, or which shall here after be granted to officers, seamen, and marines, in the naval service, disabled by wounds or injuries received in the line of their duty, shall commence from the time when they were disabled.'"

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Management of the Navy Pension Fund

The fund began investing in interest-yielding securities in 1800 and followed a fairly regular pattern of remaining fully invested with a "buy and hold" strategy until the legislation of the 1830s ultimately led to its liquidation.[12] The strategy reflected the flow of funds from prizes. As noted before, the initial legislation provided that the fund would be financed by proceeds from the sale of prizes, which would be placed in the fund and remain there for the purpose of paying the promised pension benefits. If the sale of prizes provided insufficient funds to pay the promised benefits, Congress would appropriate additional funds to make up the shortfall. That promise led the commissioners to request that Congress reimburse the fund for losses on its investment in the Bank of Columbia, which collapsed in 1824 (about which, more later). They made the request even though at the time the fund had sufficient assets to make expected payments. Shortly after Congress authorized the reimbursement of those funds in 1834, the pension program was expanded, as we have already described. If the sale of prizes yielded excess funds, the surplus was to remain in the fund to provide for future benefits. As far as we can determine, no estimates of long-term expenditures were made before the 1820s, and there was no direct link between expected revenues from the sale of prizes and expected expenditures on pension benefits.

Relying on the capture and sale of prizes provided an uncertain flow of funds into the fund for two reasons. First, the actual capture of prizes depended on the current international military and political situations, not to mention the skill of American seamen. Second, once the prizes were taken, they had to be sold and the proceeds returned to the fund in accordance with the law. The latter condition often proved as uncertain as the former, as shown in the fund's annual reports. For example, in January 1816, the commissioners wrote:

> [We] find it necessary to claim the further aid of the Legislature, not only to enable them to collect the arrearage of the prize money, which belongs to the fund, but to secure, in future, a punctual and faithful accountability on the part of those officers who are charged with the prosecution and sale of prizes, and the collection and distribution of the proceeds of the sales. The imperfections of the existing laws are great, and have given rise to many abuses. (*American State Papers,* Naval Affairs, vol. 1, report no. 134, Jan. 5, 1816, 380)

The prize monies that provided the basic capital of the fund were not consistently reported, but the data available show great irregularity and extreme variance from year to year. The irregularity of the flow of prize money manifested itself in an audit entitled "Statement of the Condition of the Navy Pension Fund," issued in 1829

12. For the details of the management of the fund's portfolio, see Clark, Craig, and Wilson 1998.

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(*American State Papers,* Naval Affairs, vol. 3, report no. 390, Feb. 20, 1829, 323). Between 1814 and 1828, the fund received $451,694.51 from the sale of prizes. Peak years of annual revenues were 1814 with $150,367 and 1819 with $174,848; however, no revenues at all were received during six of the fifteen years. A basic portfolio strategy would be to convert the prize proceeds into a regular income flow to match the somewhat more regular payments to pensioners. With a buy-and-hold strategy for government securities redeemed at par, capital gains and losses would depend on whether the original assets were bought at a premium, yielding a loss, or at a discount, yielding a gain.

Annual reports of the fund vary in their date of submission between September and the following January, and vary considerably in detail regarding vouchers. The 1824 report was not submitted, but it was finally made available in 1828, having been reconstructed well after the event. Income from the fund sometimes confused reimbursements with interest received, and in several years the dividends paid by bank stocks were neither received nor recorded to the credit of the fund. The results of the reported periodic and special audits differ from the data in the annual reports. Curiously, the quality of the financial data is probably better for the earlier reports than for the later ones.

The portfolio from 1800 through 1808 was invested in U.S. government stocks, representing a mix of coupon amounts among the Sixes, Eights, and Threes, the last sort being first purchased in 1806. (The names of the securities refer to their coupon rates.) Although the Threes had a lower coupon, the price at Philadelphia in 1805–6 ranged between $59.00 and $64.00, representing a current yield of about 5 percent. The Navy Sixes were redeemed in 1807 and the proceeds invested in the Louisiana Sixes and the Threes.

Interestingly, the Eights were redeemed in 1809 and the proceeds invested in the stock of a local bank, the Bank of Columbia, which represents the privatization we discussed above.[13] Additional shares of Columbia Bank, as it was often called, were purchased in 1810, and the stocks of Union Bank and Washington Bank were purchased in 1811 and 1812 in what appears to have been in each case an "initial public offering." Over the period 1809–13, $89,703 was spent on these local bank stocks, placing 44 percent of the fund's portfolio in private, locally traded securities.

The fund grew rapidly between 1800 and 1813, from $26,552 to more than $200,000, because of prize receipts and because annual income and gains exceeded payments to pensioners. Plentiful opportunities existed to buy nationally and internationally traded stocks (bonds) between 1809 and 1813; the U.S. debt alone was

13. The ownership and control of the Columbia Bank read like a who's who of the early republic. George Washington was a stockholder, as was Henry "Light Horse Harry" Lee, a hero of the Revolution and the father of Robert E. Lee. Among the early directors were William Marbury, the plaintiff in *Marbury v. Madison,* and Francis Scott Key. A founder and the second president of the bank, Benjamin Stoddert, was the first Secretary of the Navy (Cole 1959, chap. 3; Walsh 1940, 59–93).

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approximately $50 million. There is some evidence that commercial banks in the area were paying dividends on the order of 7 to 8 percent. The Bank of the United States paid annual dividends from July 1792 through 1810 of more than 8 percent of par, but the fund never held that asset. The fund's records of income from investments are summarized in table 1. Columbia Bank paid dividends of $3,730 in 1810, which produced a yield of 6.2 percent on the amount invested, and the Union Bank and Washington Bank yielded similar dividends.

The portfolio valuation calculations that led the commissioners to forfeit liquidity and take on the added risk for the potential additional 1 or 2 percent over bond returns from the three local bank stocks seems unconventional. This observation is important, because the fund ignored the stock of the Bank of the United States. The three bank stocks were acquired in "half" shares and "whole" shares. The subscription schedule for the initial capital in the banks provided an arrangement not unlike a time-purchase plan for acquiring the stocks. It is possible the market price was paid for an exchange, or the purchases might have been arranged in some manner consistent with the initial offerings of the capital stock. All of these and subsequent transactions in bank stocks were handled by an agent, George MacDaniel, and the privatization of the fund has the scent of insider trading.[14]

During the War of 1812, the fund more than doubled between 1813 and 1814, from $206,076 to $484,852.[15] By 1829, it had grown to almost $1 million. The assets purchased from 1814 through 1824 were concentrated on the New Sixes issued to finance the War of 1812. Yet, there were additional purchases of Bank of Columbia stock in 1815, 1818, and 1819, bringing the total expenditures for Columbia Bank stock to $99,502.60. As the authorized capitalization of Columbia Bank was $1 million, the fund owned almost 10 percent of it. The fund's total holdings of private securities in 1819 were $129,266 of the enlarged total portfolio of $874,672; thus 15 percent of the portfolio was invested in private stocks. Between 1819 and 1829, the Sixes and Deferreds were being retired, along with some of the New Sixes, while the fund acquired the new debt being issued by the Treasury in bonds bearing 4.5 percent and 5.0 percent coupon rates. At the end of 1829, the majority of the fund was invested in those securities, with a lesser amount in the New Sixes and the original Threes.

The Columbia Bank ceased accepting new business in 1823 and ended all active operations in 1828. Although the fund continued to carry Columbia stock as "assets" on its books, valued either at cost or at par value, we have excluded those assets as of

14. It was probably not a coincidence that among the directors of the bank was one John MacDaniel, Jr., though we have not yet made a connection between the two MacDaniels; the relationship among the leading families of Georgetown resembled that in New England, documented by Lamoreaux (1986). Elsewhere we explore the potential malfeasance attending the management of the fund (Clark, Craig, and Wilson 1998).

15. The fund's holdings are reported in detail in Clark, Craig, and Wilson (1998), available from the authors on request.

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year-end 1824 in table 1.[16] Recall from our earlier discussion that the acquisition of private assets inevitably increased the risk of the fund's portfolio. Now we see the downside of that decision. With the failure of the Columbia Bank, the fund lost roughly 10 percent of its value.

Typically, one would expect the owners—ultimately, the fund's beneficiaries, who after all would reap the rewards from any capital gains on the assets—to absorb such a loss; but in this case they did not. In July 1834, the fund received $167,164.40 to cover equity and forgone interest and dividends "from the Treasurer of the United States, for Columbia Bank stock purchased of the navy pension fund by the United States, per act of Congress, approved 30th June 1834." The fund's net loss from the failure of the Columbia Bank was $99,502.60. The difference of $67,661.80 must include forgone interest (at 5.32 percent) since about 1822. In other words, the taxpayers bailed the fund out, as Congress assumed the risk of privatization on behalf of the taxpayers ex post facto. Not coincidentally, at exactly the same time, Congress restored the "widows and orphans" benefits, as detailed earlier.

From 1830 through 1840 the portfolio experienced a great deal of shuffling, because almost all U.S. debt was being redeemed (for details, see Clark, Craig, and Wilson 1998). Between 1829 and 1830, there was a very large increase in the amount of the Threes and Four-and-a-halfs and Fives being held as the last of the New Sixes were redeemed. In 1829, some municipal stock in the Washington Corporation, which went under various names over a few years, had been bought. In 1832, as the Threes were being redeemed, the fund made large purchases of stock of the Second Bank of the United States, in compliance with directions by the navy.[17] As noted earlier, the restriction of purchases to the Second Bank of the United States was related to the failure of Columbia Bank and also to the practice of paying commissions to agents of the fund *while* they were on the payroll as disbursors of pension payments. The navy direction followed several audits and much correspondence from the fund for reimbursement because of inability to pay benefits to the widows and orphans. Also, state bonds of Maryland and Pennsylvania had been acquired, along with the local debt of Cincinnati, all of which paid a 5 percent coupon.[18] Indeed, practically all stocks ever purchased by the fund were at a premium, except the Threes, which typically traded at a discount because of their "less than market" coupon. In 1838 Illinois bonds and a small additional amount of local debt in Washington were added to the portfolio.

16. The exact nature of the failure of the Bank of Columbia remains something of a mystery, but evidence suggests at least three reasons: (1) poor management, (2) bad real-estate loans in the District, and (3) a misguided effort to serve as a collection agent for the Second Bank of the United States (Cole 1959, chap. 3; Walsh 1940, 59–93). Of the thirteen banks chartered in the District of Columbia by 1830, four had failed (Gallatin 1831, 99, 104).

17. This stock was purchased from the Treasury at par with no fees involved. The transactions represent subsidies, because the stock was trading at a premium at that time.

18. These stocks were bought at a premium (Clark, Craig, and Wilson 1998).

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Over the period 1830–36, the total amount of the portfolio remained rather constant in the neighborhood of $1 million, but it fell sharply by 1838 to $390,832, as stocks had to be sold to meet the fund's increased pension obligations. Interestingly, after its federal charter expired in 1836, the Second Bank of the United States was rechartered in Pennsylvania. It eventually failed and was liquidated on February 4, 1841. From October 1, 1837, through the end of September 1838, however, the fund received $510,353.90 in principal and interest from the Treasury as compensation for the bank's stock.[19] In addition to these problems, several states defaulted on their debts, and interest rates on state debt climbed to more than 15 percent as the prices of state bonds fell (Sylla and Wallis forthcoming). This collapse occurred as the fund was selling securities to meet pension obligations, and the value of the portfolio went from $253,139 at the end of 1839 to virtual depletion at the end of 1841. The only assets remaining in the fund were shares of the Union Bank and the Washington Bank, which were nearly worthless.

Conclusion

The history of the U.S. Navy pension fund and its management demonstrates that the privatization of the fund exposed it to additional risk. Once the fund realized the downside variability that characterizes such risk, Congress simply shifted the risk to taxpayers and bailed out the fund—on two different occasions. This episode offers a valuable lesson for contemporary debates about the privatization of the Social Security system. Specifically, it demonstrates the legislators' inability to credibly ensure that the risks associated with the greater expected returns from privatization were similarly privatized. Ultimately that congressional failure to link risk and return caused the support of the pensioners to be thrown back on the taxpayers. We have little reason to suspect that a similar fate would not befall such an attempt in our own time.

19. No Bank of the United States stock appears among the fund's assets after 1837 (Clark, Craig, and Wilson 1998). We do not know exactly how those shares were disposed of, though it is possible they were sold by the Treasury.

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Are We All Capitalists Now?

JOHN R. HANSON II

According to conventional wisdom, collectivism has been vanquished in all but a few infirm nations, and hence long-run economic prospects are far brighter for most of the world. The *Wall Street Journal* rejoices: "Capitalism is triumphant. Market forces have spread to every corner of the globe. National boundaries seem to be dissolving" (Wessel and Harwood 1998). A recent book by the distinguished economist and former U.S. Treasury official Paul Craig Roberts and Karen LaFollette Araujo, *The Capitalist Revolution in Latin America* (1997), also exudes optimism about capitalism's prospects. Yet free-market momentum has slowed because of the global financial crisis, widely publicized economic troubles in transitional economies, the electoral success of the Left in Europe and elsewhere, and similar events. Multilateral institutions based on the presupposition of market failure, such as the International Monetary Fund, have expanded their roles in coping with global economic problems, to the disappointment and consternation of pro-market politicians, economists, and pundits.

Are the free-market reforms of recent times secure? Are they vulnerable to reversal? These are urgent questions, although admittedly hard ones to answer, given the diversity of local politics throughout the world. It is regrettable that journalistic and other impressionistic, albeit expert, commentary dominates public discourse on these questions. A comprehensive but succinct summary of the state of economic liberalism around the world at the height of the reform movement would be helpful as we assess the vitality of the fledgling world order. Quantitative indexes of the international commitment to Smithian policies would shed light on the collective ideological mood, about which only piecemeal impressions currently exist.

The means with which to make a quantitative assessment are available in the numerical ratings of economic freedom published by the Heritage Foundation

John R. Hanson II is a professor of economics at Texas A&M University.

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(Johnson and Sheehy 1996), the Fraser Institute (Gwartney and Lawson 1997), and Freedom House (Messick and Kimura 1996). These new indexes permit the extent of diversity in economic regimes in the modern world to be described with great precision and, I believe, with enough accuracy for present purposes. In the light of this evidence, the world's commitment to economic liberalism appears more tenuous than is commonly believed.

The methodologies of the Heritage Foundation, Fraser Institute, and Freedom House studies have been compared in a valuable survey by Hanke and Walters (1997), whose article may be consulted for details. Hanke and Walters have shown not only that all three indexes are thoughtfully and meticulously prepared but also that, despite their differences, they are highly correlated with one another. For the purposes of this essay, I need only mention some basic information and make a few supplemental observations on the approaches and methodologies of the indexes.

The Indexes

To measure economic liberty, the Heritage and Fraser reports concentrate on official economic policy and practice. Equating economic liberty with procapitalist policies, their implicit standards of evaluation most closely resemble those of a foreign investor. Freedom House takes a legalistic approach, defining economic freedom in terms of an individual's constitutional right to undertake certain activities, such as owning a business or engaging in foreign trade, regardless of the official policies of the moment. Although an independent scholar, Gerald Scully (1992), employed a slightly different approach in his valuable study of economic growth under various constitutional regimes during the 1980s, the Heritage, Fraser, and Freedom House indexes represent the current frontiers of the field.

The Heritage index, which is cosponsored by the *Wall Street Journal* and is influential in official Washington, compresses into a single number its assessments of local conditions in ten areas of economic life: official trade policy, taxes, government consumption of output, monetary policy, foreign investment policy, banking policy, wage and price controls, property rights, economic regulation, and black market activity. Conditions in each area are rated on a 1–5 scale, with 1 standing for the most economic freedom and 5 for the least, on an idealized spectrum representing the business or investment climate. These numbers in turn are combined into an unweighted average, which is the summary index for each country.

The Fraser methodology arranges seventeen areas of economic life under four headings: money and inflation, government operations and regulations, takings and discriminatory taxation, and restraints on international exchange. Fraser's seventeen categories are in most respects an elaborate version of Heritage's ten, but they are explained and defended in more rigorous theoretical terms. The Fraser study places the data for each topic on a 10–0 scale running in the opposite direction from the Heritage scale, with 10 representing the most economic freedom and 0 the least.

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Country coverage is another important difference between the two studies, attributable in part to differences in their purposes. The Fraser index, intended for academic uses, is historically oriented, presenting measurements between 1975 and 1995 at five-year intervals. It covers as many as 115 countries, depending on the availability of historical data. The first volume of the Heritage index appeared in 1995; new and expanded sets of estimates are published each year. Heritage covers more of the developing world than Fraser does. Although the two studies have only 1995 in common, I have chosen to use the 1996 edition of the Heritage index for the sake of comparability and because of its expanded coverage. The inevitable delays of data collection and processing mean that it likely reflects 1995 conditions better than the original Heritage index, which presumably incorporates at least some pre-1995 data. The simple correlation coefficient between the 1995 and 1996 Heritage indexes is 0.96. The 1997 Fraser study is an improved and expanded version of Fraser's 1996 study, not a serial edition, but using either makes no difference.

Freedom House, the leading authority on political freedom and civil liberties in the world, recently expanded its scope to include the measurement of economic freedom. It shares with the Heritage Foundation, the Fraser Institute, and most economists a firm belief in the salutary effect of economic freedom on economic performance, but its definition of economic liberty flows from its own philosophical tradition and departs from custom among professional economists. Freedom House concentrates on the constitutional situation, distinguishing between economic freedom and normal economic policy, although it concedes that the two may intersect. Freedom House's main indicators are the freedom to hold property, to earn a living, to operate a business, to invest one's earnings, to trade internationally, and to participate in the market economy. Each of these categories includes a number of secondary criteria, such as the presence or absence of intellectual property rights, legal discrimination against women and children, and a right of voluntary association for economic purposes such as wage bargaining. The rating scale runs from 0 (not free) to 16 (free). A country's score is the sum of scores on each of the six main criteria listed previously. The scale for each score is 0–3 in most cases, but 0–2 in some.

Freedom House's iconoclasm is illustrated by the case of Singapore, which has a low tax rate, a small share of national output consumed by government, and liberal policies toward foreign investment—preeminent hallmarks of economic liberty from the Heritage and Fraser points of view. Freedom House, however, rates Singapore only "partly free," because of its strict controls of trade unions, the lack of official neutrality in competition between public and private companies, and its official refusal to recognize business ownership as a right rather than a privilege.

The country coverage also is narrower in the Freedom House study than in the Heritage and Fraser studies, amounting to only eighty-two countries. Those seem to have been chosen because of their prominence or importance in the world: Freedom House remarks that they represent 90 percent of world population and 99 percent of

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global output of goods and services. Industrial countries, representing about a quarter of the sample, bulk larger than in the other samples. Furthermore, if Freedom House is correct to assert that higher incomes accompany economic freedom, the rest of the sample is likely to be biased toward economically free countries as well. The summary statistics calculated from the Heritage and Fraser samples move a little toward the free-market end of the scale when those samples are matched to the Freedom House sample. Thus, even if Freedom House's definition of economic freedom is accepted, summary statistics from the Freedom House study almost certainly overstate the extent of global economic freedom.

Findings

Means, medians, and coefficients of variation for the Heritage, Fraser, and Freedom House indexes are presented in unweighted (strictly speaking, country-weighted) and population-weighted forms in table 1.[1] The table also includes subcategories of the data. The subcategories match those used in the Fraser study; I assigned countries from the other studies according to Fraser's obvious logic of classification. Former Soviet republics are classified separately. The Heritage Foundation identifies a rating of 3 on the 1–5 scale as the boundary between, in its terminology, mostly economically free and mostly economically unfree. The comparable point on the 10–0 Fraser scale would be 5 and on the Freedom House scale, 8.

The top line in each panel contains the summary statistics for the samples and subsamples (the sizes of which appear in parentheses) covered in each study. According to the unweighted means and medians, the typical country in panels A and B hovers around the middle of the scale, diverging little in either direction. In neither case does the typical country seem dedicated to free enterprise. Notice that the full-sample Heritage results tilt to the illiberal side and the Fraser results to the liberal side. These distributions both appear to be statistically normal, according to standard tests, which is another interesting discovery,[2] but the centering of the distributions near the midpoints of these arbitrary scales appears coincidental. The Fraser data for 1985 (not shown) are centered to the left of both the scale's midpoint and the 1995 results, corroborating the common perception of a general trend toward economic reform in the recent past.

The population-weighted results, which describe economic regimes in terms of the number of people within their jurisdiction, are more revealing. As shown in panels A and B of the table, the weighting procedure causes the summary measures to move

1. The population data are taken from World Bank (1997) and occasionally supplemented with estimates from United Nations Development Programme (1995).

2. The Shapiro-Francia test and the test developed by D'Agostino, Balanger, and D'Agostino (1990) were used.

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Table 1: Summary Statistics for Heritage, Fraser, and Freedom House Indexes

	Unweighted			Weighted		
	(1) Mean	(2) Median	(3) Coefficient of Variation	(4) Mean	(5) Median	(6) Coefficient of Variation
A. Heritage Index						
All (142)	3.10	3.05	0.25	3.34	3.65	0.21
Asia (22)	3.15	3.08	0.33	3.61	3.75	0.14
Africa (35)	3.43	3.40	0.14	3.43	3.25	0.13
Latin America (27)	3.08	3.00	0.20	3.26	3.35	0.13
Europe/ Middle East (27)	3.17	2.95	0.25	3.53	3.45	0.22
Former Soviet (11)	3.55	3.50	0.16	3.64	3.50	0.09
Industrial (20)	2.14	2.08	0.13	2.10	2.05	0.13
B. Fraser Index						
All (115)	5.27	5.50	0.27	4.92	4.40	0.26
Asia (15)	6.10	6.30	0.26	4.70	4.40	0.19
Africa (30)	4.21	4.15	0.24	3.91	3.90	0.26
Latin America (24)	5.80	6.15	0.18	5.11	5.50	0.24
Europe/ Middle East (20)	4.59	4.75	0.26	4.03	4.10	0.22
Former Soviet (6)	4.42	4.25	0.22	3.54	3.50	0.10
Industrial (20)	6.55	6.45	0.15	6.93	6.70	0.12
C. Freedom House Index						
All (82)	9.84	11.00	0.47	7.49	7.00	0.62
Asia (15)	7.00	7.00	0.58	5.19	6.00	0.61
Africa (8)	8.25	8.00	0.46	6.61	4.00	0.58
Latin America (13)	9.38	10.00	0.38	8.71	8.00	0.33
Europe/ Middle East (16)	9.25	10.50	0.47	8.21	8.00	0.52
Former Soviet (11)	7.18	7.00	0.61	6.52	7.00	0.34
Industrial (19)	14.95	15.00	0.06	14.95	15.00	0.08

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toward economic illiberalism. The hypothesis of statistical normality is rejected for the weighted Heritage distribution, although not for the corresponding Fraser distribution. The population-weighted distribution is skewed dramatically. About 43 percent of the world's population live under regimes rated between 3.7 and 4.0 on the Heritage scale. Omission of the industrial countries changes that figure to 49 percent. The weighted distribution in particular implies the absence of a definitive break with collectivist ideology.

The specific country groupings in the rest of table 1 provide more food for thought. Two broad similarities between the top two panels deserve particular attention. First, population weighting challenges perceptions of the demise of collectivism or statism even more emphatically than does country weighting. The general conclusions reached above do not pertain just to localized circumstances or atypical cases, such as extraordinarily populous India and China, countries that for statistical purposes are classified in the same region. Second, the differences between the estimates for the industrialized countries and the rest are large in both panels. Weighting the estimates sharpens the distinction between the industrial category and the others: estimated economic liberty actually drifts toward the "free" extreme for the rich countries. This comparison is enlightening because industrial countries impose on themselves many laws, regulations, and social programs that restrict their output of goods and services; they are hardly free-enterprise countries in an absolute sense. That most of the world compares poorly to such countries reveals that alternative systems remain deeply entrenched.

Perhaps that point is moot, given the speed of economic reform around the world. The Fraser estimates provide a preliminary basis for assessing the world rate of reform. Between 1985 and 1995 the unweighted median of the Fraser estimates rose from 4.1 to 5.3 and the weighted median from 3.6 to 4.4. For nonindustrial countries the comparable figures are 4.1 and 4.8 for the unweighted estimates and 3.4 and 4.5 for the weighted ones. The trend of the various means is approximately the same. If we treat the numbers for the nonindustrial countries as representing a rate of shift of roughly 25 to 30 percent per decade in the center of the distributions, then in 2005 the nonindustrial countries should average in the vicinity of 5.5 or 6.0 on the Fraser scale, or substantially below the level of today's industrial countries. This admittedly rough approximation indicates that not even a simple and presumably rosy extrapolation of recent history, by most accounts an exceptionally favorable period for economic reform, implies a comprehensive commitment to free-market economic policies in the nonindustrial world in the near future.

Panel C of the table contains the summary statistics for the Freedom House index. According to the unweighted results on the top line, the typical country comes closer to free markets—8 is the scale's midpoint—especially if the median is taken to be the better measure of central tendency. The bias in the Freedom House sample, however, makes it hard to view these findings as contrary to those based on the Heritage and Fraser indexes. This point is reinforced by the population-weighted results,

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for which the summary statistics fall short of the midpoint of Freedom House's scale. It is not likely that inclusion of the omitted countries would make economic freedom in the constitutional sense seem normal for most of the world's population.

The rest of panel C embellishes and, on the whole, supports these inferences. The industrial countries, for which the weighted and unweighted results are identical, are head and shoulders above the rest in economic freedom, especially in the weighted estimates. They also are similar to each other, as evidenced by the tiny coefficients of variation in columns 3 and 6. The statistics in panel C, however, do not strictly contradict the analogous ones in the other panels. Notice, too, that the continent of Africa is underweighted in the total Freedom House sample. Africa is reputed to be an economically illiberal region for the most part, so that inclusion of more African countries (including North Africa) likely would create an even gloomier picture of economic freedom in the world.

In light of the philosophical and methodological differences between Freedom House, on one hand, and the Heritage Foundation and the Fraser Institute, on the other, the correlation of the Freedom House estimates with the others is also of interest. The simple correlation coefficients for identical samples are –0.78 and 0.66, respectively, for Heritage and Fraser. Both coefficients are statistically significant, and they have the same meaning despite their opposite signs. The weighted correlation coefficients are about the same. The lower correlation coefficient (in absolute value) between the Freedom House and Fraser estimates is not surprising, given the distinct theoretical and methodological contrasts. Still, these coefficients are greater than might have been expected. They imply a direct association between capitalistic economic policies and economic rights. The coefficients drop, however, if the industrial countries are removed from the samples. In that case, they become –0.66 and 0.54, respectively—again, both are statistically significant—for the unweighted estimates. For the weighted estimates they are –0.59 and 0.43, indicating that the Freedom House estimates continue to track the others, albeit less closely.

A more striking difference lies in the high variability of the Freedom House estimates, as revealed by the coefficient of variation. For most regions or classifications of countries the dissimilarities among the Freedom House estimates exceed the dissimilarities among the other estimates by a large margin. A more rigorous comparison obtained by matching the three samples (68 countries) yields coefficients of variation of 0.34, 0.25, and 0.25 for Freedom House, the Heritage Foundation, and the Fraser Institute, respectively, a less striking difference. But matching Freedom House and the Heritage Foundation samples (77 countries) produces coefficients of variation of 0.45 and 0.29, again markedly different.

Taken at face value these comparisons imply that international differences in economic policy regimes tend to be smaller than differences in economic rights. Among conceivable explanations of these findings, one possibility is particularly tantalizing. Perhaps international agreement is greater on economic policy or the need for a good business

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climate, especially for foreign investors, than on the desirability of a liberal legal environment or extensive economic rights for the domestic population. The middling correlation coefficients between Freedom House and each of the other indexes just described for the nonindustrial world are consistent with this conjecture. It is arguable, furthermore, that competitive forces would produce greater convergence of policies affecting foreign capital than of freedoms accorded domestic citizens, the latter being less salient abroad and more closely linked to local politics, history, and culture.

Conclusion

The three ambitious studies summarized in this article all disclose that even before the start of the global financial crisis of the late 1990s the revealed preferences of nations raised doubts about assertions of capitalism's global ascendancy. Commitment to the market throughout most of the world was half-hearted at best, notwithstanding widespread impressions to the contrary. A reversal of liberal reforms in some places therefore should come as no surprise. The process, in fact, may already have begun. The Heritage Foundation describes 1998 as a year in which economic freedom receded in the world (Johnson, Holmes, and Kirkpatrick 1999). To be sure, old-style collectivism has few forthright defenders in today's world. Secular trends in world opinion favor the market and economic freedom, however defined, and many procapitalist regimes exist. Yet the key fact is the timidity with which capitalism has been embraced in most places, leaving the new world capitalist order highly vulnerable to attack by its recently rejuvenated enemies.

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Michael Polanyi's Economics

PAUL CRAIG ROBERTS AND T. NORMAN VAN COTT

People familiar with Michael Polanyi are impressed by his intellectual powers, the range of his mind, and his ability to get to the heart of issues, often long before anyone else. These attributes also apply to his work in economics. In *Full Employment and Free Trade,* published in 1945 by Cambridge University Press, Polanyi synthesized Keynesian economics and the monetary school of economics later associated with Milton Friedman. In constructing that synthesis, Polanyi preceded the best minds in the economics profession by at least two decades, perhaps three.

That achievement was remarkable, especially for the time. It was widely believed then that John Maynard Keynes's *General Theory of Employment, Interest and Money* had established the irrelevancy of monetary economics. As Friedman later put it, monetary policy was "twice damned" and was considered a useless remedy for unemployment. Moreover, Keynesians also thought that their theory established that full employment was not the natural state of a free economy.

Amid this confusion stood Polanyi, talking in the same breath about full employment and free trade (by which he meant a free market, as opposed to a planned economy)—conditions considered to be mutually incompatible—and setting out in detail a monetarist explanation of Keynes's theory. Not only did money matter; Polanyi showed that money was all that mattered.

Lack of training as an economist allowed Polanyi to avoid pitfalls that confused economists. It also left him unaware of the magnitude of his achievement. He saw himself as a Keynesian, but in fact he achieved, in the early years of Keynesianism,

Paul Craig Roberts is chairman and John M. Olin Fellow at the Institute for Political Economy in Washington, D.C., and **T. Norman Van Cott** is a professor and chairman of the department of economics at Ball State University.

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before the monetarist critique, an integration of the two approaches that other economists did not create until the 1970s.

Needless to say, Polanyi got no credit for his achievement. He was too far ahead of his time and too far outside his bailiwick. Had he possessed an economics chair and graduate students, he might have been in contention as the most important economist of his time, eclipsing both Keynes and Friedman by his early synthesis. Economics and public policy would have been spared the long and pointless Keynesian odyssey toward big government.

Keep in mind that in 1945 economists still did not know that the Federal Reserve had caused the Great Depression by allowing the supply of money to shrink by nearly a third. That story was to be told later by Friedman and Anna J. Schwartz. In England the unemployment problem had begun earlier, when the British government tried to reestablish the pre–World War I parity of the pound with gold and the dollar. That policy required a deflation that deprived the economy of a sufficient supply of money to maintain full employment. When the government abandoned its attempt to return to the pound's prewar parity, Britain started to recover. But at the time there was a jumble of voices. Some were Marxists bent on overthrowing the capitalist order. Keynes spoke in a more reassuring voice.

Unemployment of workers and other resources, Keynes said, reflected an insufficiency of total, or aggregate, demand. As a solution, he proposed that the government turn to deficit finance. By spending more than it collected in tax revenues, it would add to aggregate demand.

Keynesians have a diagram, which still appears in economics texts, that shows the sum of consumer and investment demand crossing the aggregate supply schedule at a point below full employment. In such a situation, the government calculates the gap in demand and fills it with the appropriate budget deficit.

Keynes had his finger on a source of the trouble. Aggregate demand was insufficient. But what he, or the Keynesians, did not understand was that demand was insufficient because the supply of money was insufficient.

Polanyi understood that an insufficiency of money lay at the root of the unemployment problem. He produced movies, which he showed to audiences all over the United Kingdom. The movies showed what he called the "Money Circle" and the unemployment that resulted when the circulation of money, or the "Money Belt," was not wide enough to maintain full employment. Polanyi's diagrams had the additional advantage of showing that "squirting" money into the economy would not cause inflation until the Money Belt widened beyond the width necessary for full employment.

In *Full Employment and Free Trade,* Polanyi used the concepts and terminology he had developed for his films for public audiences. A "squirting pump" injecting money onto a "Money Belt" may have struck economists as childish terminology and kept them from appreciating the challenging theoretical concepts that Polanyi had developed. If he had not felt the responsibility to inform the public and, instead, had

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used mathematical equations to express the relationships, he might have advanced the economics profession twenty years in one swoop.

On the other hand, Polanyi might intentionally have pitched his appeal to the public on the bet that academics and intellectuals were a lost cause. He was up against more than terminology, theory, and analysis. The same predisposition toward planning that Polanyi had fought in science was abundantly present in economics. His solution for unemployment—money creation—required no extension of the government's sphere of influence. But an increase of the size and scope of government was precisely what "modern" economists sought. They maintained that full employment was impossible in an unplanned market economy. As William H. Beveridge expressed it in *Full Employment in a Free Society:*

> Full employment cannot be won and held without a great extension of the responsibilities and powers of the State exercised through organs of the central Government. No power less than that of the State can ensure adequate total outlay at all times, or can control, in the general interest, the location of industry and the use of land. To ask for full employment while objecting to these extensions of State activity is to will the end and refuse the means. (p. 36)

Polanyi realized that an insufficiency of demand reflected an insufficiency of money. That realization permitted the maintenance of full employment without the need for national economic planning and without running up the national debt. It was unnecessary to incur public debt and the obligation to make interest payments when the real purpose of the fiscal deficit was only to satisfy an excess demand for money and absorb an excess supply of goods and labor. The government should finance its deficit by issuing new money. In other words, Polanyi proposed using Keynes's fiscal deficit to implement an expansionary monetary policy. Even today this idea is advanced for economists, who still think of monetary and fiscal policies as distinct.

Polanyi's wedding of monetary and fiscal policy solved a difficulty that monetarists later pointed out in the Keynesian system. Monetarists showed that financing a deficit by borrowing does not increase aggregate demand unless the central bank "accommodates" the fiscal policy by expanding the money supply. Because it is the expansion of money that increases demand, Polanyi's policy of issuing new money to finance a deficit achieves the same result that monetarists understand the central bank to achieve when it buys bonds to expand bank reserves. In a depression climate of fear and uncertainty, Polanyi's solution works more directly, because it is independent of the willingness of borrowers to borrow and lenders to lend.

The Keynesians of Polanyi's day intended to use public-works spending to fill the gap in aggregate demand. Polanyi objected: not only was such spending pointless when money creation was costless, but the public works would distort the allocation of resources, violate the neutrality principle, and drive down the return from public

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investment far below the return in the private sector. Polanyi argued that a balance must be maintained between public and private expenditures so that the joint satisfaction derived from both would be a maximum. That principle requires that government expenditures be rationally determined on their merits as investments and that the nation's resources not be squandered to fill a gap in aggregate demand or to fight "social evils."

Because Polanyi understood the depression in terms of a shortage of money, he understood its prolonged continuation as a consequence of a continuing insufficiency of money, which frustrated the public's determination to build up its cash balances. In Keynesian terms, the excess demand for cash balances meant that saving could exceed investment for a lengthy period, thereby sustaining the "deflationary gap."

The imbalance would be corrected by issuing money to cover fiscal deficits. "There is a balance between all the needs of man," Polanyi wrote, "and when a certain measure of financial security is attained, the desire for more will be abated" (pp. 41–42). The rate of saving will fall. Money will be redirected to consumption, and the Money Belt will widen, eliminating the need for deficits.

In 1945 many economists and policy makers believed that depression would resume after the end of World War II. Polanyi, however, predicted correctly that the cash

> balances accumulated during the course of this war are likely to reduce the rate of thrift . . . considerably for a time after the return of peace, and that their possession may even cause the public to spend at a rate which may threaten inflation. In the light of such suppositions it may appear likely that the chronic excess of Savings over Investment and the consequent state of permanent depression, which have so sorely tried the highly industrialized countries in this century, could have been all avoided merely by allowing the public to accumulate cash balances. (p. 42)

No economist has ever written truer words.

Polanyi's Adaptation of the "Pigou Effect"

Gottfried Haberler in 1937 and A. C. Pigou in 1943 showed that a downward wage-price spiral had the effect of increasing real money balances. As price declines drove up the value of the existing money supply, the increase in real money balances would at some point satisfy savings desires and result in a resumption of consumption. Pigou later dismissed the "Pigou effect" or "real balance effect" as an academic exercise, because a government would not employ a downward wage-price spiral as a means of increasing the real money supply. In contrast, Polanyi recognized the real-world policy implications of the real balance effect. He dismissed the wage-price flexibility discussion as irrelevant and stated the "Pigou effect" in terms of constant prices and in-

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creases in the nominal stock of money. In Polanyi's approach, the policy issue is not obscured by adverse effects on expectations caused by price-level declines.

The Predilection for Planning

By 1945, when Polanyi's book was published, the issue for many economists was no longer full employment. Keynesian full-employment policy had become a stalking horse for a vast program of social reform. The idea that economic life should ever again be left to the market was beyond the pale for progressive thinkers—regardless of whether full employment could be maintained by careful regulation of monetary circulation. Even the conservative authors of the 1944 White Paper on employment policy were committed to the planning of public investment as a full employment policy and worried that "civilian production, when it is resumed, may concentrate on the wrong things from the point of view of national needs" (p. 7).

In his assessment of the White Paper, M. Kalecki noted that budget deficits are not the only path to full employment: "The same end can be achieved by redistribution of income from higher to lower income grades" (p. 135).

In Britain the issue was "Plan or No Plan." The "no plan" position called for planning public works to offset fluctuations in private investment. The "plan" position called for planning private investment as well, if not the entire economy. In 1945 T. Balogh could welcome the king's speech for announcing the intention to nationalize the Bank of England and set in place "machinery to provide for the effective planning of investment." Balogh noted that in order for the government to operate the economy in the national interest, finance would have to be controlled no less than materials and labor.

In *Full Employment and Free Trade,* Polanyi subjected the White Paper on Employment Policy and the Beveridge Plan to devastating criticisms, which are as analytically sound today as the day they were written. In addition, he devoted two chapters to showing that the totalitarian powers, Soviet Russia and National Socialist Germany, did not secure full employment with planning but with increases in monetary circulation.

Polanyi, however, was confronting an intellectual force much more powerful than the Keynesian income-expenditure model and unsubstantiated notions about economic planning. He realized that economic analysis alone could not influence the intellectual and emotional attitude that attributes irrationality and social injustice to societies that evolve on their own by cultivating beliefs inherent in their traditions. Instead, this attitude seeks justice in a society revolutionized from above by "pure and sensitive souls" motivated by "the charming spectacle of the public good." Polanyi would later use those words of Robespierre to good effect when, recognizing that the real challenge was an excess of moral passions, he moved on to diagnose the pathology of our time as "moral inversion."

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REVIEW ESSAY

Can Anarchy Save Us from Leviathan?

ANDREW RUTTEN

These days, it seems that anarchy is everywhere. Its fans range from Yale law professors (Ellickson 1991) to pulp novelists (Ferrigno 1996; Mosley 1998). Last fall, it even showed up in the *New Yorker*, where it was touted it as "the next big thing" in law enforcement (Rosen 1997).

At first glance, it is hard to understand this fascination. Most of us equate anarchy—literally, "the absence of the state"—with chaos and mayhem. Following Hobbes, we reason that without the state to enforce rights, venality would reign and society would lapse into the war of all against all, making our lives "solitary, poor, nasty, brutish and short." Who, except the most depraved sociopath, would want such a condition?

The advocates of anarchy would answer "not us." The theme of their work is that Hobbes, Locke, and almost everyone else are wrong about anarchy. The advocates point to the growing body of theory and evidence that life in anarchy isn't at all as most people imagine it. Whether we look at businessmen in Wisconsin, diamond merchants in New York, or farmers in Sri Lanka, we find that "order without law" is not just a slogan but a way of life (Macaulay 1963; Bernstein 1992; Ostrom 1990). Those anarchies work because, *contra* Hobbes, they do not lack an enforcer of rights.[1] Or rather, instead of a single enforcer—the centralized monopolist we call the state—anarchies have a variety of decentralized enforcers, such as markets, firms, and communities. Thus, anarchies avoid chaos by providing lots of folks with an incentive to pitch in and punish deviants.

Andrew Rutten is a fellow at Liberty Fund, Inc.

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For a small but growing group of anarchists, rehabilitating anarchy is only the first step toward reconstructing liberal political theory. For them, liberal theory errs by treating the state as a necessary evil, rather than an unnecessary one. The anarchists argue that the state is evil because it invariably abuses its power, violating the rights of some for the benefit of others, and that it is unnecessary because even without it we would still have social order and respect for each other's rights. From their perspective, "limited government" is a contradiction in terms, a project that simply cannot succeed. Thus, for them, the job of the political economist is not to tame the state but to teach us how to do without it.

In the essays in *Against Politics,* one of our leading anarcho-liberals, Anthony de Jasay, argues the case against the state with flair and insight. He claims that the only consistent liberal is an anarcho-liberal. He takes his inspiration from Edmund Burke, who wrote, "In vain you tell me that Artificial Government is good, but that I fall out only with the abuse. The Thing, the Thing itself is the Abuse" (p. vii). In explaining why government "itself is the Abuse," de Jasay ranges widely, giving us essays on topics from contractarian theories of the state to multiculturalism and rights. He arranges the essays into two broad sections. In the first, called "Excuses," he examines carefully a variety of arguments for government. Whether we think of the state as necessary (the third party that is essential to keep us from each other's throats) or merely convenient (a better way to keep us from each other's throats) or fixable (a basically good idea that has been corrupted by bad people or rules), de Jasay wants us to see that we are wrong. For him, the analyses that underlie such accounts, whether set in the state of nature, behind the veil of ignorance, or in the shadow of the prisoners' dilemma, are just happy fictions designed to hide an unhappy truth: "States are an imposition, sometimes useful, sometimes a millstone, always costly, never legitimate, and never a necessity for binding agreements" (p. 36). In the second part of the book, called "Emergent Solutions," he expands on the claim that a successful liberal society—one in which people's rights are secured against all aggressors—doesn't need a state. Against the orthodox view of anarchy as chaos and mayhem, he argues that anarchy need not be so bad, and usually is much better. We find that argument novel only because we've heard Hobbesian jeremiads against anarchy so often that we treat them as established fact.

De Jasay makes serious charges. If they are true, then much of what we think we know about good government is wrong. Unfortunately, even sympathetic readers may find it hard to go all the way with him. Such readers will almost certainly agree with his critiques of existing theories of the state, whether descriptive or prescriptive. They are also likely to agree that anarchy has gotten short shrift in the modern world, that far

1. For explicit models of anarchic order, see Benson 1990; Klein 1997; Taylor 1982, 1987, and 1996; or the survey in Rutten 1997.

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too many of us unthinkingly toe the party line on the benefits of the state. But before accepting the claim that anarchy is always superior to the state, they will want more. They will want an explicit comparison, so they can see for themselves that anarchy actually is better. Without such a comparison, readers must worry that they are making the very mistake of which de Jasay accuses his statist foes: simply asserting that their favorite would win the Hobbesian horse race, rather than proving it would. Although de Jasay's accusation may be an understandable response to three hundred years of statist mendacity, it isn't good political economy.

At this point, readers may be tempted to conclude that my argument with de Jasay amounts to arid pedantry, a sectarian tempest in a libertarian teapot. That would be a mistake. As noted earlier, anarchy is all the rage among those who find contemporary interest-group politics sordid and ineffective. Because de Jasay has thought longer and harder about anarchy and the state than most other anarcho-liberals, taking him seriously allows us to better understand their arguments as well.

But close examination shows that anarchy needn't be as happy as de Jasay implies. If we treat his defense of anarchy the way he treats liberal analyses of the state, asking what incentive people have to comply with its rules, we will not necessarily reach his conclusions. The reason is simple: even in anarchy, some have power over others. And they can abuse that power, using it to benefit themselves at the expense of others. Thus, to show that some anarchic arrangement would be superior to the state, we need to show that it wouldn't be the sort of anarchy in which people abuse their power. De Jasay doesn't consider this issue directly, but examples ranging from Bosnia to the mafia suggest that he should, that anarchy is not automatically liberal.

Despite this lacuna in his argument, serious liberals ignore de Jasay at their own risk. Even the reader who agrees with everything I say here would benefit from reading de Jasay for himself. Obviously, I can touch on only a few of the themes of his book. But, more important, my own essay is fundamentally de Jasian, asking of him the same question he asks of traditional liberals: "This sounds nice, but how will it really work?" Thus, even skeptical readers will learn much from him. They may even find themselves persuaded.

The Liberal Case for the State: Anarchy Is Intolerable

When asked for their political creed, most liberals would say that they want a government that protects the rights of its citizens against predators. If pressed further, most of them would identify that government with a state, an institution with a monopoly on the legitimate use of violence. They would base their argument for the state on a comparative institutional analysis, one that examines the extent of social order provided by various governance institutions.

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Most such comparisons are fairly abstract, based on stick-figure renderings of life under the available alternatives. Since Hobbes, the comparisons have usually begun by considering a society of people living in the state of nature, that is, without a state. Nowadays, that society is modeled as some sort of social dilemma, such as the well-known prisoners' dilemma.[2] The dilemmas arise whenever people are more productive working with others than working alone, but individually best off shirking rather than working, no matter what others do. In such situations, rational people would always shirk, because shirking is the best response to whatever others do. Of course, when everyone reasons that way, nobody works and they end up back where they started, in autarky. Thus, acting rationally leads them to forgo any of the gains from cooperation. This outcome is both individually sensible (nobody could do better by behaving differently on his own) ***and*** wasteful (if only they would cooperate, each would be better off).

This sorry outcome confronts the members of society with a dilemma: given the choice between everyone working and everyone shirking, everyone prefers that they all work; yet given the incentives they face, none of them will work. They will not work even if they sign a contract promising to do so. Such promises would not be, in the jargon of game theory, "credible." Because each knows that when it comes time to act, everybody will have an incentive to go back on his word, everyone will treat a promise to work as what it is—empty talk. Moreover, this situation poses a true social dilemma, because it is rooted in their strategic circumstance, not their psychology.[3]

At this point, liberal theorists introduce the state. They do so by asking why people who are giving up obvious gains don't get together and find some way to resolve the dilemma. The traditional liberal answer is that they would do so. And when they got together, people would adopt a social contract creating a third party empowered to force them to do what they cannot do themselves: enforce contracts and other rights. By punishing those who do not respect rights, the state changes the incentives. With the addition of that threat, people no longer face social dilemmas. Instead, they face trivial coordination games, in which the only rational course is to cooperate and reap the gains from trade. Under those conditions, nobody cheats, cooperation flourishes, and everyone is better off.

For most liberals, recognizing the need for a state is only the first step toward a sound political economy. After all, there are many different social contracts, or ways of organizing governments. Should the rulers be chosen from one family, a group of families, or the general citizenry? And under what terms should they rule? For life? Until the next election? Or until the revolution? Liberals want answers to these questions because *how* a society makes choices—the specific decision rule that it uses—

2. For discussion of the extent to which modern game theory captures the approach of the classics, see Hampton 1986; Kavka 1986; and Taylor 1987.

3. That is why the game is better called the prisoners' dilemma than the prisoner's dilemma.

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usually determines *what* it chooses. The same group of people using different rules might choose different policies—often, radically different policies.

The recognition that institutional rules influence outcomes has revived interest in constitutional design among fans of limited government. In the past few decades, liberal scholars from James Buchanan to Robert Nozick to Richard Epstein have investigated the consequences of a variety of different rules, always with the hope of finding a rule that, if obeyed, leads to better choices than the rules we now use. The proposed solutions range from heightened judicial review to term limits to balanced-budget amendments. In spite of their differences, each analyst traces inferior policy choices directly to the political structure. In this view, politicians do not choose the policies because they are less civic-minded than others; they choose them because the political system gives them both a motive and an opportunity to do so. A structural ailment requires a structural cure. Of course, the specific solution depends on the particular problem to be solved.

The Liberal Case against the State: Let's Take the Con out of Constitutional Political Economy

For de Jasay, standard liberal theory is fine as far as it goes, but it does not go nearly far enough. In particular, he notes that it says nothing about the incentives of politicians to actually obey any particular set of rules. That omission is hardly a trivial one. After all, to do its job, the state must be strong enough to force any other group in society to obey its commands. And, because it consists of people with their own interests, the state will often have an incentive to abuse its power by violating the rights of citizens for its own benefit. As a result, it seems that the liberal simply replaces one problem (how to get citizens to respect each other's rights) with another (how to get the sovereign to respect the rights of citizens). Although some argue that anarchy is so bad that any state, even an abusive one, would be better, not everyone agrees. Many liberals side with John Locke, who doubted that "men are so foolish that they take care to avoid what mischiefs may be done them by pole-cats or foxes; but are content, nay, think it safety, to be devoured by lions" ([1690] 1980, 50).

Classical liberal theorists of the eighteenth and nineteenth centuries took Locke's observation seriously. They worried that the people who make up the government wouldn't obey constitutional rules unless doing so was in their interest. That worry led them to examine the incentives created by the constitutional rules, to see whether they were strong enough to force politicians (and others) to obey the rules. If the incentives were not compatible with the rules, a constitution would be, in the words of James Madison, merely "a parchment barrier" (Madison, Hamilton, and Jay [1788] 1987, 309). To strengthen the barrier, many liberals argued for such institutions as separated powers, federalism, and an independent judiciary. They wanted those institutions for prudential, rather than ethical, reasons. Such institutional arrangements,

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they believed, would give even the most narrowly self-interested politicians an incentive to serve the public interest.

Modern liberals agree that the classical liberal institutions failed because the constitutional rules that they established did not channel self-interest effectively enough to restrain predation. For them, that failure can be corrected by restructuring the government, changing the rules so as to provide better incentives. Yet, as de Jasay points out, when asking what new rules we should adopt, liberals tend to ignore issues of constitutional politics, that is, of how the constitution will be chosen and maintained. They do not try "to find the conditions, if there are any, under which [constitutions] would be likely to be adopted, respected and left intact for long enough to do any good" (p. 53). Instead, contemporary advocates of limited government implicitly assume that constitutional politics differs radically from ordinary politics. They justify that assumption by invoking devices such as the veil of ignorance, behind which people have very little idea how their decisions will affect them, or unanimous consent, which effectively gives everyone a veto. Under such conditions, decisions about constitutions are depoliticized, and therefore people choose constitutions with special features.

But as de Jasay points out, the liberals' neglect of constitutional politics is problematic precisely because the analysis of ordinary politics underlying their critiques of existing constitutions is so convincing. That analysis assumes that people will do whatever is economic to get outcomes they want. If achieving their objectives requires altering or overturning the constitution rather than ordinary politics, they will not be deterred. They will want a constitution that leads politicians to adopt policies that favor them. Their ability to actually get the preferred constitution will depend on what others want, and on how *they* choose. In the United States, constitutions are normally chosen and amended using representative methods. Nor are constitutions enforced in an institutional vacuum. In the United States, courts decide whether or not the acts of the other branches of government are consistent with the constitutional mandate. The judges who make those decisions are chosen by politicians. Taken together, the foregoing conditions make it seem likely that real constitutions will be susceptible to venal considerations, contrary to the assumption of liberal theorists.

These considerations lie at the heart of de Jasay's critique of liberal constitutionalism. He begins by taking on the idea that a constitution is a social contract, adopted in the state of nature. "If," he asks, "contracts require an enforcer, how could there be a social contract creating an enforcer without *its* enforcement being assured by a meta-enforcer created by a meta-social contract, and so on in an infinite regress?" (p. 5). In other words, is it consistent to assert that people who could not enforce private contracts could enforce a social contract? Given the complexity of the social contract, the obvious answer is that they could not. The contradiction leads de Jasay to label this part of the liberal project "Self-Contradictory Contractarianism" (chap. 1).

He goes on to argue that showing that a particular constitution *could* improve policy does not prove that it would in fact do so. We must also show that any particular

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constitution would be chosen and enforced. We need to ask, in the jargon of economics, whether it is incentive compatible. When it comes time to enforce the rules, who will do the dirty work? Will those who are supposed to enforce the rules have any incentive to do so? De Jasay points out that this problem parallels the one faced by private contractors in the state of nature: how to create a self-enforcing agreement. As he so charmingly puts it, the constitution is like "a chastity belt whose key is always within reach" (p. 3), because the very people against whom the constitution is supposed to be enforced are the ones who are supposed to enforce it. In a chapter entitled "Is Limited Government Possible?" he points out that the logic of democratic politics, in which coalitions are notoriously unstable, makes it seem likely that compliance will be fleeting (p. 56). Most of those who lose when the constitution is enforced will be able to bribe away enough of the complying coalition to form their own, noncomplying, winning coalition.

The lesson that de Jasay draws from this analysis (and from others) is that the self-seeking by our fellow citizens creates worse problems than are predicted by the standard liberal creed. In particular, he argues that liberals are overly optimistic about their ability to design institutions that will channel self-interest in public-regarding directions. If he is right, it seems that we must choose between anarchy, in which we are impoverished by the depredations of our fellow citizens, and tyranny, in which we are impoverished by the depredations of the sovereign. Either way, our prospects look bleak.

The Case for Anarchy: Repeated Prisoners' Dilemmas Are Not Prisoners' Dilemmas

At this point, de Jasay makes his most radical claim. He tells us that despite the failure of the liberal constitutional program, our prospects aren't so bad. On the contrary, they are actually pretty good. This is so because it turns out that we have neglected an option: anarchy. We have limited our options because we have misunderstood the incentives created by life in anarchy. When we understand anarchy correctly, we see that it can protect us from each other.

The major difference between the Hobbesian and the de Jasian view of anarchy is that de Jasay, like other anarcho-liberals, takes into account a central fact of social life: not everyone is a stranger. Whether at work or at play, most of us find ourselves dealing again and again with the same people. This fact makes a huge difference for strategic behavior. Put crudely, the knowledge that we will see people again gives us a powerful incentive to be nice to them, because if we are not, they may not be nice to us in the future. Facing that threat, even the most narrowly self-interested, brutally calculating egotist might find that it pays to act like Mother Teresa. Because this account is central to de Jasay's claims, and because he touches on it only briefly, it is worthwhile to explore the underlying logic of the rational-choice account of anarchy in some detail.

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Stripped to its core, the argument for anarcho-liberalism is that the Hobbesians mischaracterize anarchy when they treat it as a series of isolated two-person deals. Doing so ignores the obvious fact that most of our dealings with others are embedded in a rich web of social relations. In game-theoretic terms, that embeddedness moves society from one-shot games to repeated games. And, as is now well known, cooperation is rational in repeated games. It is rational not because dealing with each other again and again changes peoples' preferences or because it allows them to learn who is honest and thus trustworthy. Rather, people cooperate in repeated games because doing so pays them more than not cooperating. It pays more because, as long as the future value of the relationship exceeds the onetime gain from cheating, people can punish each other by not cooperating in the future.

Thus, in the shadow of the future, people can make what economists call *implicit* or *self-enforcing* contracts, agreements that bind them without the help of any third parties. Such a contract exemplifies an *equilibrium institution,* a set of rules obeyed because everyone finds it in his interest to obey. Of course, besides following the rules about their own behavior in the social games they play with each other, people must also follow the rules about monitoring compliance and punishing deviants.

The idea of a self-enforcing contract, if not the terminology, lies behind much of the empirical literature on "order without law." For example, few business arrangements resemble the classic arms-length agreements enforced by courts that used to populate textbooks in economics and law. Instead, in many instances real contracts are better thought of as *relational contracts,* deals between people who expect to have a long (and prosperous) relationship. Moreover, in the shadow of the future, people can sustain cooperation even with strangers. They can do so because, even though we may not deal with any one person often, we do deal with the same group of people repeatedly. Even in the modern world, many of our relationships take place in communities, groups of people who have overlapping relations. We can use those communities to enforce cooperation by expanding the terms of cooperation, so that we respond not just to our own history but to everyone else's history as well. In that way, people who belong to a community can use the other members as third parties to enforce their agreements (Greif 1993; Kreps 1990).

In a very real sense, communal enforcement allows one to offer his reputation as a bond to guarantee his behavior. The reputation embodies the future value of cooperation with other members of the community. Extending repeated games from dyads to communities brings the models much closer to what we usually think of when we think of anarchic institutions such as communities and norms. Most descriptions of norms stress the importance of reputations and of communal, third-party enforcement. For example, Robert Ellickson argues that ranchers and farmers in Shasta County, California, do not rely solely on self-help to enforce norms. They also rely on the threat that other members of the community will not cooperate with defectors.

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The use of reputations to induce cooperation among the members of a community increases the level of cooperation, but at a cost. For communal reputations to work, people need much more information than they have in the repeated two-person prisoners' dilemma. Instead of knowing just their own history, they need to know everyone else's history as well. Eventually, the costs of gathering and disseminating that information may become so large that they exceed all of the gains from cooperation. If people cannot contain those costs, then the communal reputation mechanism will destroy itself.

Throughout history, people have developed a variety of methods to economize on the flow of information needed to support reputations. One common method is to empower some citizens to hear and resolve disputes, leaving enforcement of the decision to the general citizenry. Thus, in medieval Europe, long-distance merchants often brought their disputes to judges at trade fairs (Milgrom, North, and Weingast 1990). The judges would investigate and then announce their decision. Losers who did not pay in accordance with a judge's ruling faced the threat that other merchants would not trade with them. Similarly, in East Africa, disputes over cattle were traditionally settled by an official known as the Leopard Chief, an ordinary citizen with absolutely no enforcement power (Bates 1981). Yet, once his decision had been announced, both parties to the dispute abided by it. They did so not only out of respect for his abilities and wisdom but also because of the threat that others would punish them if they did not.

This brief tour of repeated games shows why de Jasay and others invoke it to argue against the Hobbesian understanding of life without the state. The repeated-game approach to anarchy has several noteworthy features. First, it treats the institutions that support cooperation as equilibria that must provide all parties, including enforcers, with incentives to do their jobs. Second, it treats anarchic institutions, such as norms, not in isolation but as part of the fabric of daily life. Like Hobbes, anarcho-liberals start with people in a state of nature and show how they can build effective institutions. As a result, the incentives to conform to anarchic institutions must come from the games of daily life among the citizens; those games are literally the only source of rewards. Finally, notwithstanding their origin in a Hobbesian state of nature, none of the institutions that arise are Hobbesian. Even those that rely on a central authority to collect information rely on decentralized methods to enforce the rules.

The Case against Anarchy: Anarchists Too Will Abuse Their Power

So far, the story of anarchy seems happy: when people deal with each other repeatedly, as they usually do, they have an effective method of punishing those who do not respect the rights of others. Thus, it seems that Hobbes was wrong, that anarchy *can*

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work. However, this account must answer an obvious question: If anarchy is so wonderful, why did so many people believe the Hobbesians? Were they just blind to the anarchic alternative, or is anarchy perhaps more complicated than the optimists suggest? Could it be, as suggested by my own survey, that anarchy promises no particular outcome and that the provision of social order outside the state may take many forms? For example, we might buy our justice on the market, as people do when they hire private guards or arbitrators. Or we might rely on a community for enforcement, as people do in all traditional societies.

However we conceive of anarchy, we don't have to look far to see it being abused. Those who invoke anarcho-capitalism, complete with buying and selling protection on the market, need look no farther than the mafia, a private institution that both provides justice and preys on its clients. (Indeed, it uses its power to force even the unwilling to become its clients; often, the predator it protects against is itself!) Many anarcho-capitalists argue that in the market for justice, as in the market for cars, competition will limit rent collection. That argument ignores some rather obvious opportunities for collusion among anarchists. With more than one firm providing justice, the firms will have to work together when their clients have claims against each other. Without more detail, it is hard to see why such cooperation won't sometimes lead to collusion against weaker clients (Cowen 1992). (For a thorough discussion of real-world examples, see Benson 1998.) It is also hard to see why the competition among such firms will be any more effective than that among politicians, political parties, and jurisdictions in modern democracies. Yet the anarcho-liberals all agree that existing political competition does not provide sufficient threat to prevent abuse of power.

Anarchic governance through communities faces similar problems. Throughout history, most communities have been the setting for various sorts of oppression. For example, communal enforcement is easier when the community is ethnically or religiously homogenous, and many communities treat outsiders badly. Nor are all insiders treated equally well. For example, traditional societies often impose heavy burdens on women, among others. Finally, most traditional societies have enforced harsh norms of equality, often forcibly redistributing wealth (Cook and Miller 1998). Given the relatively great inequalities in the distribution of wealth in modern capitalist societies, it is hard to be sanguine that modern communities will resist the redistributionist urge. Certainly, the record of small towns opposing "threats" such as Wal-Mart suggests otherwise.

Those familiar with the theory of repeated games will not find these sad stories surprising. The happy results discussed earlier are only a part of the story of repeated games. Contrary to the claims of many of its popularizers, that theory does not show that cooperation is the only rational strategy. Rather, it shows that in repeated games, many outcomes, including cooperation, are rational. The reason is simple, and illuminating: there is no single natural or unique way to distribute the surplus generated by cooperation. As long as all players get more than they would under feasible alternatives, they will go along. Thus, the proper interpretation of the theory of repeated

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games is that repeated play raises a new question: Among the many different outcomes, all of which distribute the gains from cooperation differently, which should be chosen? In other words, as de Jasay points out, repetition turns social dilemmas into coordination games, in which people want to cooperate, but on terms favorable to them. Whether any particular anarchy ends up with a liberal outcome, with rights enforced against all parties, depends on which of the many feasible outcomes the anarchy "chooses." Without more information about the choice process, we have no reason to suppose that, in general, anarchy is more liberal that the state.

The lesson here is not that de Jasay is wrong about anarchy and that we can comfortably return to our traditional statist-liberal verities. No doubt, he and other anarcho-liberals have shown that anarchic order is both theoretically and factually robust. Given the weight of that reasoning and evidence, it would be foolish to argue for a return to the Hobbesian status quo. However, it would also be foolish to ignore the contrary evidence and to argue that anarchy is so good that surely we can do without the state. What we need is an anarchic constitutional political economy, a study of what life would be like under the various possible anarchic institutions.

The Poetry of Power

In many ways, the preceding criticisms miss the most important lesson of de Jasay's book, which is the importance of the poetry of power, that is, of the way we talk about governance. Again and again, he urges that we resist seduction by the easy analogies of liberal statists and refuse to accept as proved what has merely been asserted. Instead, he would have us join him in going behind such metaphors as "consent," "social contract," and "state of nature" to ask what is really going on in any particular society. Querying metaphors, we find that they do not always illuminate; instead, they often lead us to skip over crucial details that analyses such as de Jasay's expose and emphasize.

After reading de Jasay, one appreciates that much of the appeal of the Hobbesian program lies in its congruity with common sense. All of us rely on some model of what makes people tick to guide us through the social world. For most of us, that model resembles what philosophers call "folk psychology" and includes an ample allowance for self-interest and venality. Starting from that bleak picture of human nature, we easily conclude that Hobbes was right and that life in the state of nature, where order comes from anarchic institutions, would be terrible. From that perspective, cooperation without the state seems an unattainable ideal, a goal that only the most saintly might seek. It seems perverse or naive to suggest that we rely on anything but the state to protect us.

De Jasay's account suggests that this presumption is not well founded. Moreover, the counter-account does not reject folk psychology but embraces it wholeheartedly. From its perspective, ordered anarchy is not an unattainable ideal but part of the web of institutions, simply one more way that people order their social world. And,

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like other governance institutions such as firms, markets, and states, anarchic institutions can (and should) be treated as an incentive system that can be understood only by close examination of the incentives and opportunities it presents to individuals.

To implement that approach, de Jasay (along with many others) builds models in which rational egoists confront a much richer strategic environment than they do in the simple models, such as the prisoners' dilemma, that generate Hobbesian outcomes. Even the richer models remain sparse and abstract. Nevertheless, as my brief tour shows, their minimal enrichment of the environment suffices to overturn completely the Hobbesian account of anarchy. In these models, as in reality, anarchy can work.

When performed carefully, rational-choice analysis suggests that anarchy is far more complicated than either de Jasay or his Hobbesian foes make it out to be. Anarchy's foes err by asserting that it is inconsistent with social order; both theory and evidence show that the richness of social relations may lead even the most brutal egoists to cooperate rationally. And anarchy's friends, like de Jasay, err by asserting that its lack of hierarchy is equivalent to a lack of coercion or that anarchic institutions are accepted in ways that statist institutions are not. The social order in anarchy often rests on appeals to the basest sort of self-interest. That anarchic institutions are equilibria implies that self-interest will lead people to "accept" any outcome that gives them more than they could get in autarky. Hence, compliance need not imply consent in any ethically interesting fashion. Because people will try to attain those anarchic institutions that favor them, anarchy is likely to be subject to the same crass considerations that guide ordinary politics and will not automatically offer an alternative superior to the state.

Despite these caveats, the evidence shows that de Jasay is right at the most basic level: *it is time to throw off the Hobbesian yoke.* For too long, Hobbes's claim that anarchy was so bad that anything would be better has limited the imagination of institutional designers. Seduced by that false inference, they have ruled out some important options on the grounds that they could not be effective. But we know too much about both Leviathan and its alternatives to accept such a view.

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REVIEW ESSAY

The Great Depression Revisited

ROGER W. GARRISON

Professors Thomas E. Hall and J. David Ferguson, both of Miami University of Ohio, have combined social history and macroeconomic theory to achieve an understanding of the world between the wars. Their book *The Great Depression: An International Disaster of Perverse Economic Policies* (Ann Arbor: University of Michigan Press, 1998) takes its place on library shelves among many others with the same main title. A search in Auburn University's library reveals more than a dozen such volumes, differentiated only by their subtitles, as well as numerous others that deal with the same subject. Though the authors break no new ground, their book is distinguished by its particular blend of monetarist and Keynesian ideas and by a presentation liberally colored with the prose of John Kenneth Galbraith and Frederick Lewis Allen.

Hall and Ferguson's account of the world's longest economic slump has the distinct advantage of being reader-friendly. It begins with a "Great Depression Timeline" that chronicles the major economic, political, and military events on a year-by-year basis from 1914 to 1941. And it ends with a glossary that includes key players, key writers, and technical terms. The opening chapter presents the authors' list of seven important questions to be answered. Among them are the critical questions about the depression's origins, scope, intensity, duration, and eventual resolution. Was the bust related to the preceding boom? What gave the depression its worldwide character? Why was it so deep and so long-lasting? How was recovery eventually achieved? Still

Roger W. Garrison is a professor of economics at Auburn University.

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other questions in their list deal with subsidiary issues concerning movements in the operating ratios of the banking system (reserves to deposits and currency to deposits) and with the coexistence of unemployment and inflation during portions of the 1930s. The book's subtitle establishes the theme underlying most of the answers, and the sequencing of the issues in the middle chapters is partly logical and partly chronological. The final chapter repeats the seven questions and offers summary answers. To help readers who are not trained in economics to follow the arguments, the authors digress at several points to explain some fundamentals, such as the significance of the parity ratio that relates the values of two gold-based currencies, the quantity theory of money, and the real-bills doctrine.

Contrasting Visions

Perspectives on the Great Depression can be categorized in terms of two contrasting visions of the relationship between the economy and the government. In one vision, the economy is inherently unstable, and government policy is stabilizing; in the other, the economy is inherently stable, and government policy is destabilizing. Ferguson and Hall's perspective is largely but not wholly consistent with the latter vision. Referring to a critical phase of the depression (1930–31) during which unemployment increased dramatically, the authors hold that the worsening conditions are attributable to "a combination of economic ignorance, confusion, and incompetence [of] U.S. policymakers" (p. 104). Evidently, though, those policy makers were able to overcome their ignorance, confusion, and incompetence when they turned their attention (in 1933–35) to matters of banking and finance. In that area, they produced what Hall and Ferguson call the "best legislation to come out of the New Deal" (p. 115), the establishment of the Federal Deposit Insurance Corporation being "the single most important change" (116). The anticompetitive effects of that legislation (the cartelization of the banking industry, the prohibition of interest on checking account balances, the imposition of interest-rate ceilings on savings) are downplayed. The cumulative and still ongoing effects of the moral-hazard problem inherent in subsidized deposit insurance get no mention at all.

From Boom to Bust

The raw facts are that times were good in the twenties and bad in the thirties. Why so? The stark contrast between the two decades begs for an explanation. It seems helpful (to this reviewer) to make a first-order distinction between two general questions: (1) What was the nature of the transformation from good times to bad times? (2) Why were those particular bad times so awfully bad? Although Hall and Ferguson make this distinction in some contexts (e.g., p. 75), the critical importance of the first question can easily be overshadowed by the dramatic stories told in answering the second. Hall and Ferguson draw on Barry Eichengreen to characterize their view: "What converted

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a garden variety recession into the Great Depression was a disastrous series of policy errors" (p. 164). The perverse economic policies highlighted by Hall and Ferguson certainly have a claim on our attention. But what about the characterization of the initial downturn? To call it a garden-variety recession is to be wholly dismissive of the most critical—though not the most dramatic—aspects of this boom-bust episode. The question of what made a bad situation get worse is allowed to crowd out the question of why the situation was bad in the first place. Further, "garden variety" suggests that recessions of the sort that occurred in 1929–30 are inherent in the nature of the market economy. (In fairness, we should note that Eichengreen may have been quoted out of context. Writing for *Challenge* [vol. 35, no. 2, 1992] about the international character of recessions, he refers to the shortsightedness of "'Voltairean Economics'—the idea that policymakers need only tend their own gardens." When, two paragraphs later, Eichengreen used the term "garden variety recession," did he mean a recession thought to be remediable without the cooperation of other countries?)

In an early chapter, Hall and Ferguson do raise the issue concerning the nature of the initial downturn. Unfortunately, their questions are ill framed, their analysis ignores the relevant literature, and their answers are ambivalent and unsatisfying. "Did factors building up during the 1920s set the stage for the Great Depression?" (p. 13). After raising that very reasonable question, the authors immediately recast it in terms of "payback time": "Did the Great Depression amount to 'payback time'? Was the Great Depression a natural correction following the prosperous twenties?" Here, the authors themselves have conflated the issue of the nature of the initial downturn with issues concerning subsequent exacerbations. There is no school of thought according to which the whole of the Great Depression, as defined by its unprecedented depth (25 percent unemployment) and spirit-breaking duration (more than a decade), is to be attributed to excesses of the 1920s or to ill-conceived policies that gave rise to those excesses.

There is a school of thought according to which policy-driven booms contain the seeds of their own undoing. The Austrian school distinguishes between genuine (and hence sustainable) economic growth and artificial (and hence unsustainable) booms. In a market economy, an intertemporal equilibrium, as maintained by the rate of interest, requires a consistency between the allocation of resources among the various stages of production at any given point in time and the desired pattern of consumption over time. A reduction of interest rates may reflect a change in intertemporal consumption preferences. In such a case, the resulting reallocation of resources away from current consumption and toward investment—and from relatively late stages to relatively early stages of production—will eventually play itself out as a temporal shifting, a forward shifting, of consumption. That, apart from technological advance, is the essence of (genuine) economic growth. By contrast, a reduction of interest rates may reflect credit creation by the central bank. In that case, the resulting process that governs the intertemporal allocation of resources will not play itself out but rather will do itself in. Artificial booms inevitably end in busts.

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The unsustainability of credit-driven booms is the essence of the Austrian theory of the business cycle as set forth by Ludwig von Mises early in the century and developed by F. A. Hayek in the 1920s and 1930s. Whereas Hayek saw his theory of boom and bust as accounting for the transformation from good times to bad times, Hall and Ferguson fail to evaluate the claims made by Hayek or by modern Austrians, or even to recognize the existence of the Austrian theory of the business cycle. They assess instead a few selected remarks by "the great social historian" (p. 23) Frederick Lewis Allen and some conjectures by one of capitalism's harshest critics, John Kenneth Galbraith.

There can be no doubt that the United States experienced a boom in the 1920s. During an eight-year period (1921–29), the economy grew from trough to peak at the rate of 5.9 percent. Hall and Ferguson compare that growth rate to the country's long-run average of 3.0 percent and describe it as "quite remarkable" (p. 17). By itself, the unusually high growth rate gives some plausibility to the Austrian view: the boom may have been quite remarkable but not quite sustainable. Hall and Ferguson (e.g., p. 18) suggest that the boom stemmed from technological change. More specifically, after World War I the new assembly-line techniques had a dramatic effect in several key industries, including automobiles, household appliances, and food processing. This account of the boom implies a strong demand for investment funds and hence upward pressure on interest rates. Actual movements in interest rates and changes in credit conditions, however, serve to bolster the Austrian interpretation of the episode. The authors' own charts show that downward pressure was stronger than upward pressure: the corporate-bond rate and the commercial-paper rate declined throughout the boom (p. 7). The supply of credit evidently outpaced the demand for it. However, the credit was being supplied not by market participants who had suddenly become big savers but by a central bank that had just turned its attention from financing a war to fostering prosperity in a peacetime economy. These are the considerations that weigh in favor of an Austrian account of the economy's transformation from good times to bad. The Fed-fostered prosperity did not and could not last.

The question of the boom's sustainability is raised indirectly by Hall and Ferguson (p. 28) when they focus on stock prices just before the crash. They uncritically cite some recent studies, including Harold Bierman's *Great Myths of 1929* (New York: Greenwood Press, 1991), that purport to demonstrate that stocks were not overvalued even in 1929. The demonstration, however, is wholly question-begging. Conventional present-value calculations that might have been applied by a portfolio manager in the late 1920s are adopted as the critical test. It can easily—and tellingly—be shown on that basis that *if* we extrapolate the (high) growth rate into the indefinite future and *if* we discount the corresponding profits at the prevailing (low) rate of interest, then the resulting present value of capital assets are consistent with the actual (extraordinarily high) stock prices. "In other words, if investors expected earnings to continue growing from 1929 to 1934 at a rate similar to what had occurred from 1925 to 1929,

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then the stock prices prevailing in September 1929 were very much in line with fundamentals" (p. 28). Surely, though, the exercise leads us to a conclusion quite opposite to Bierman's, as summarized by Hall and Ferguson. The so-called "fundamentals" turned out to be "superficials." If, in retrospect, we see that stocks were dramatically overvalued in 1929, we conclude that interest rates were artificially low and that the growth rate was unsustainably high. The downturn was not some "garden variety recession" but rather the inevitable result of a credit-induced boom.

Hall and Ferguson rightly dismiss the argument that "the worsening distribution of income" (p. 20), or, as economic historian Jim Potter put it, "the failure to redistribute income" (p. 22), was responsible for a waning of consumption and hence for the downturn in 1929. But then, after pitting Galbraith's bubble-ready-to-burst view against Bierman's (and others') stocks-weren't-overpriced view, they conclude that "the jury is still out on whether the stock market advance of the late 1920s was due to speculative excess or to fundamentals" (p. 29). In their final chapter, however, the jury seems to have come back in. The authors report a hedged verdict of speculative excess (p. 161). Such courtroom metaphors inspire this reviewer to claim that the prosecutors simply failed to call on the most pertinent expert witnesses, namely Mises and Hayek. Those witnesses would have testified that a dramatic rise in asset prices is characteristic of an economy in the final throes of an unsustainable boom.

A Tiger by the Tail

Understanding the nature of the boom would seem to be a prerequisite to understanding the "cause" of the subsequent bust. But although Hall and Ferguson lack confidence in their assessment of the economic circumstances in 1929, they seem very confident in their judgment about the cause of the downturn. They share the widespread belief among economists that "restrictive monetary policy initiated by the Federal Reserve Board in response to the stock market boom was the cause of the initial economic slowdown that eventually turned into the Great Depression" (p. 30). If the stock prices in the late twenties were actually anchored in the fundamentals, then the (uncalled-for) restrictive monetary policy is rightly seen as the cause of the downturn. If, however, the speculative excesses were themselves the result of overly favorable credit conditions maintained by the Federal Reserve, then to attribute the downturn to subsequent monetary restrictions is, at best, misleading.

Borrowing imagery from Hayek, we can say that the Federal Reserve "had a tiger by the tail." How long could or should it hold on? How long could or should it try to sustain an ultimately unsustainable boom? Holding on meant continuing to fuel the speculative excesses; letting go meant putting an end to the boom. The Federal Reserve's decision to let go (though undoubtedly the tiger would soon have whipped the Fed loose) certainly helps to explain the timing of the downturn, but the cause of the downturn would have to be traced to the credit conditions that eventually culminated

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in the speculative excesses—and ultimately to the 1913 legislation that created an activist central bank. The tiger-by-the-tail metaphor is intended to imply that in 1929 a "soft landing" was not a possibility. The Austrian view does not deny that a soft landing may have been possible in, say, 1927, and it does not imply the inevitability of a catastrophic crash of the sort actually experienced. The recession ushered in by the inevitable hard landing could have been as short-lived as the recession of 1920–21.

Policies Exacerbating the Contraction

Hall and Ferguson are right to offer not a single cause but a list of causes for the depth and duration of the Great Depression. Smoot and Hawley's tariff of 1930, Hoover's tax hike of 1932, and Roosevelt's farm program (marketing quotas and price ceilings) of 1933 certainly belong on the list. Further, Hall and Ferguson are right in singling out the 1937–38 recession for separate attention. The 1935 labor legislation (the Wagner Act) gave awesome powers to organized labor (pp. 142–44), and the 1935 and 1936 tax legislation, which raised tax rates and made the tax schedule more steeply progressive (pp. 145–47), had predictable depressing effects.

Most important, the Federal Reserve, acting on a gross misperception of the operating ratios of commercial banks, committed a policy blunder of unprecedented proportions (pp. 148–51). The Fed interpreted the $3 billion in excess reserves held by commercial banks in early 1936 to mean that banks wanted to hold a high level of reserves—rather than as a sign that banks wanted to keep a good portion of their reserves out of the "required" category. To preclude the possibility of a monetary expansion outside the policy makers' control, the Federal Reserve raised the reserve requirement (in 1936 and 1937) to match the actual reserves being held. The subsequent efforts by commercial banks to reestablish a cushion of nonrequired reserves caused the money supply to collapse and sent the economy back into recession. As Hall and Ferguson's presentation affirms, that particular black mark on central banking is best viewed as an instance of "economic ignorance, confusion, and incompetence"—in spades.

In answering the question of what made a bad situation worse with respect to the early 1930s, Hall and Ferguson rely heavily on Friedman and Schwartz's *Monetary History of the United States, 1867–1960* (Chicago: University of Chicago Press, 1963). Perverse Federal Reserve policies were responsible for eleven thousand bank failures and a 33 percent reduction of the money stock. "The direct result was falling consumer expenditures and business investment, which led to the loss of millions of jobs" (p. 77). Departing from Friedman and Schwartz, at least in their emphasis, the authors see the perverse policies as stemming from the Federal Reserve's slavish adherence to the fallacious real-bills doctrine. As conventionally understood, that doctrine holds that as long as the central bank meets the needs of trade by rediscounting real bills only—that is, by accepting only short-term self-liquidating loans as collateral—the

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credit supplied by the central bank can exert no inflationary pressure. The doctrine is wrong, of course, because it ignores the effects of money creation on the prices that underlie those real bills.

Hall and Ferguson make use of the doctrine, or an implied corollary, in the context of an economy sinking into depression. The corollary is sufficiently distinct from the doctrine itself that it deserves its own statement. The authors' understanding of the doctrine as applied in good times (p. 82) suggests how the bad-times corollary might be stated: If the central bank rediscounts real bills only, even when the volume of real bills is dramatically diminished by continuing recessionary conditions and even when demands for liquidity are high, then the accompanying deflationary pressures are of no concern to the central bank. But, as Hall and Ferguson recognize, those pressures should be of paramount concern to the central bank. They are right to emphasize the role of monetary contraction in making a bad situation worse. It is true that the real-bills doctrine was on the minds of the framers of the Federal Reserve Act, as evidenced, for instance, by the act's preamble. But, can the reduction of the money supply to two-thirds its previous level in the span of three years be attributed to a dogged application of the real-bills doctrine? In the spirit of the rest of the book, we would surely have to suspect that the direct consequences of that fallacious doctrine were highly leveraged by more general "economic ignorance, confusion, and incompetence" on the part of the Federal Reserve.

Hall and Ferguson's account of the worsening of conditions in the early 1930s could have been strengthened by a greater emphasis on Hoover's high-wage policies. Their list of aggravating factors does include "the maintaining of high wages by the government" (p. 76), but that particular policy perversity, especially in conjunction with the precipitous fall in the money supply, deserves greater attention. Because labor is a major input in the production process, high wage rates translate into high prices. The equation of exchange, $MV = PQ$, helps us to see how the economy received a dizzying one-two punch from Hoover and the Federal Reserve. With M (and V) falling and P kept from falling, the economy could only adapt through a dramatic reduction of output, Q. When the authors protest that the Hoovervilles of the period should have been called "Federalreservevilles" (p. 104), they are only half right. Hoover deserves his share of the blame. Curiously, the authors cite in other contexts Gallaway and Vedder's *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: Holmes and Meier, 1993) but fail adequately to incorporate that book's treatment of Hoover's high-wage policies. (None of the attention to Hoover here should be construed to deny that monetary deflation can cause major problems all by itself or to downplay the further damage done by the more direct interferences with price adjustments by Roosevelt's National Recovery Administration.)

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A Shift in Perspective

In their chapter on economic recovery, the authors seem to lose their moorings and to take as givens many of the perversities they have earlier identified. The shift in focus from "How did we get into the depression?" to "How did we get out?" is accompanied by a shift in perspective from monetarist to Keynesian: "The root cause [of low output and high unemployment in 1933] was low aggregate demand" (p. 122). Aggregate demand was in fact low in 1933, but its lowness was not the cause, let alone the root cause, of low output and high unemployment. The authors' point seems to be that policy should have been aimed not at propping up prices but at pumping up demand. "The solution," they write, "was to stimulate aggregate demand to reverse the deflation . . . [not] to stop the deflation by simply fixing wages and prices."

Accordingly, Hall and Ferguson are critical of New Deal regulations but not of New Deal spending. Even the make-work programs administered by the infamous three-letter agencies (CCC, CWA, PWA, WPA), which "employed people to do a wide variety of things" and supported "artists, writers, and musicians," are seen as consistent with their understanding of the "root cause" of the economy's problem. Despite all the peacetime spending, though, the depression lingered on. Full recovery had to await the military mobilization that preceded the entry into World War II. When the authors ask in their final chapter what brought an end to the depression, they answer with one dose of monetarism and two doses of Keynesianism: It was a "combination of very rapid monetary growth that began in 1938, the 1940 increase in sales of war material to Britain, and the U.S. defense buildup that also began in 1940" (p. 163f).

Gold or Paper

The Keynesian twist to an otherwise monetarist story line may strike the reader as puzzling. Even more puzzling, however, is the authors' dim view of the gold standard, which runs as a strong subtheme throughout the book. Gold, they point out, provided the link that gave the Great Depression its international character. Their perspective on alternative monetary arrangements certainly supports the conclusion that an international gold standard and an activist central bank are incompatible institutions. It would seem, though, that their flagging of the many instances of gross mismanagement of the partly-and-then-mostly paper standard and of the "economic ignorance, confusion, and incompetence" that underlay the mismanagement would cause them to favor a decentralized, impersonal monetary system.

To favor a gold standard in that sense is not, of course, to defend Britain's attempt to maintain a prewar parity when it returned to the gold standard in 1925. And favoring gold entails condemnation of the U.S. policy of sterilization. Hall and Ferguson, however, ally themselves with those who "recognize that monetary systems are a proper sphere of influence for government" (p. 32); they account for the popular attraction to gold in terms of its supposed "mystical power" (p. 32); they poke fun at "grown-

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ups" (Steve Forbes and Jack Kemp) who see gold as a solution rather than a problem (p. 36); and they fantasize that, under a gold standard, teenagers could reduce the money supply—for instance, by their faddish demand for gold earrings following the public wearing of one by a U.S. president (p. 36).

But could teenagers or any other group on either side of the market for gold have as devastating an effect on the money supply and hence on the economy as the Federal Reserve had in the interwar period? Gold may have its faults, but if the choice is between gold and paper, the historical record, including Hall and Ferguson's account of the Great Depression, comes down on the side of gold.

Hall and Ferguson's *Great Depression* may have a substantial impact on both education and research. Its reader-friendliness makes it easy to use in the classroom. Its presentation as a stock-taking exercise makes it a convenient starting point for further research. Both qualities are signs of healthy progress toward a better understanding of the Great Depression. In short, the book helps to shift the focus of debate in the right direction. We can move on from the old debate between those who believe that depressions just happen and those who think that government policy makers may have contributed to their happening. New debate can aim at determining the precise scope of the perverse economic policies and identifying the particulars of the perversities that have for too long given the market system a bum rap.

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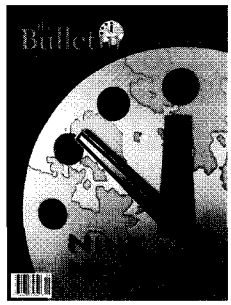

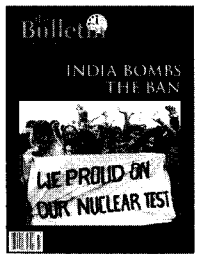

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BOOK REVIEWS

✦ Congress: A Political-Economic History of Roll Call Voting

By Keith Poole and Howard Rosenthal

New York: Oxford University Press, 1997.
Pp. xi, 297. $85.00 cloth.

This is the most important book on Congress written in the 1990s. Its presentation is flawed. I am not even sure it is a "good book" in the usual sense. But in terms of lasting importance, Keith Poole and Howard Rosenthal's *Congress* is a landmark.

In general, Pool and Rosenthal argue that the classical spatial model of politics doesn't explain real-world political conflict very well. The theory that voters weigh candidates' positions on many issues before choosing a candidate imposes unrealistic (and unnecessary) costs of information and search on voters. Somehow, issues get bundled and simplified. In Poole and Rosenthal's view, the bundling is achieved primarily through the competition among political parties.

That claim leads immediately to an apparently fatal problem (as I myself have often been told by my colleagues in political psychology): we have known for thirty-five years that individual belief systems are not consistent and are not constrained in the sense of obeying a set of ideological precepts (Phillip Converse, "The Nature of Belief Systems in Mass Publics," in *Ideology and Discontent,* ed. David Apter [New York: Free Press, 1964]). How can a simple "ideological" space describe political conflict if voters are not "ideological"?

The answer, it seems to me, has three parts. First, in terms of spatial theory, the answer is that constraint is imposed on voters by the institutions of aggregation, such as parties in competitive elections and a legislature in which a few parties elaborate a consistent and coherent message. "Constraint," in this sense, is imposed on voters, so

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that politics is ideological even if voters are not explicitly so. The intellectual history of this first step, as presented by Poole and Rosenthal, is interesting and important. The first person to argue formally that there are multiple spaces, including a complex multidimensional world of *policy* and a simplified "basic space" of *politics,* was Peter Ordeshook ("The Spatial Theory of Elections: A Review and Critique," in *Party Identification and Beyond,* ed. Ian Budge, Ivor Crewe, and Dennis Farlie [New York: Wiley, 1976]). That insight was developed further, with an explicit mechanism for moving from the politics to the policy, and vice versa, in later publications (Lawrence Cahoon, Melvin Hinich, and Peter Ordeshook, "A Statistical Multidimensional Scaling Method Based on the Spatial Theory of Voting," in *Graphical Representations of Multivariate Data,* ed. P. C. Wang [New York: Academic Press, 1978]; and Melvin Hinich and Walker Pollard, "A New Approach to the Spatial Theory of Electoral Competition," *American Journal of Political Science* 25 [1981]: 323–41).

The second part of the answer, which is almost completely ignored in *Congress,* is that, though people may not be coherently ideological, ideologies shape the way we think about almost everything in social life. There is a growing consensus among a variety of authors that ideological constraint, imposed or otherwise, sharply circumscribes how citizens conceive of the choices available to the polity. Leaving aside my own favorite source (Melvin Hinich and Michael Munger, *Ideology and the Theory of Political Choice* [Ann Arbor: University of Michigan Press, 1994]), consider three other important perspectives.

> Ideology is an economizing device by which individuals come to terms with their environment and are provided with a "world-view" so that the decision-making process is simplified. (Douglass C. North, *Structure and Change in Economic History* [New York: Norton, 1981], p. 49)
>
> Ideologies perform an important psychological service because without them people cannot know, assess, and respond to much of the vast world of social relations. Ideology simplifies a reality too huge and complicated to be comprehended, evaluated, and dealt with in any purely factual, scientific, or other disinterested way. (Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* [New York: Oxford University Press, 1987], pp. 37–38)
>
> Ideology is not the mark of sophistication and education, but of uncertainty and lack of ability to connect policies with benefits. . . . Parties use ideologies to highlight critical differences between themselves, and to remind voters of their past successes. They do this because voters do not perceive all the differences, cannot remember all the past performances, and cannot relate all future policies to their own benefits. (Samuel Popkin, *The Reasoning Voter: Communication and Persuasion in Presidential Campaigns,* 2d ed. [Chicago: University of Chicago Press, 1994], pp. 51–52)

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If such claims are correct, then much of the theorizing about politics coming out of the rational-choice and political-psychology schools is ill directed. Poole and Rosenthal in particular fall into the trap of restricting their consideration of ideology to an elite-level phenomenon. But even though the "constraint" may originate at that level, it is at the mass level that ideologies play their most important role as organizing principles. Poole and Rosenthal ignore the entire literature on this question.

The third step in the argument is empirical testing. In particular, does the notion of a "basic space" with only one, two, or three primary dimensions of conflict really tell us anything about the history of the political economy? After reading this book, no one could argue otherwise. The method, though it has been criticized on technical grounds (see, for example, James Heckman and James Snyder, Jr., "Linear Probability Models of the Demand for Attributes with an Empirical Application to Estimating the Preferences of Legislators," *Rand Journal of Economics* 28 [1997]: 142–58), clearly produces a measure of the organization of political conflict and depicts the placement of the actors in that conflict. The data represent by far the most ambitious effort to map the history of politics in any nation.

Further, because Poole and Rosenthal have a legitimate theory (the political space is consistently much smaller than the policy space, but the dimensions of the political space are strategically manipulable), their exploration of the data amounts to more than just a long story. Poole and Rosenthal really have something to teach us. It is useful to consider three main points: (1) the mechanics of dimensional conflict and the fit of the model, (2) the dynamics of regional conflict and factional discord, and (3) the appropriate way to model roll-call votes.

Mechanics. The statistical machinery (developed jointly by Poole and Rosenthal in a series of papers stretching back two decades) does two things. First, it creates a space of political conflict, using a multidimensional scaling algorithm. The dimensions of the space are latent, in the sense that, *by construction,* whatever structure is present in the clustering of issues that divide the major parties constitutes the first dimension. Second, the legislators are located in that space, using the voting pattern that each exhibited on the issues that went into the creation of the aggregate space.

It is tempting to name the dimensions of conflict something such as "economics" or "social policy" or "values," but that is generally a bad idea. It is *possible* that the primary dimension of political conflict coincides neatly with some identifiable "issue," but in general it need not do so. For example, in the 1840s the main issue became extension of slavery to the territories, but the real dimension of conflict was the status of slavery itself. Poole and Rosenthal identify the primary dimension in that era as "race," which seems safe enough. But in other periods the primary dimension recovered through the statistical procedure is simply the way of clustering issues that provides the best fit, given the presumed total number of dimensions.

Intra-party disagreement. The second dimension of conflict (when one exists; often the primary dimension explains most of the political differences in roll-call vot-

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ing), again only a product of the statistical machinery Poole and Rosenthal apply, measures the extent of disagreement within parties. If the two parties are perfectly cohesive, then political conflict will always be one-dimensional, because two points determine a line in a space of any dimension from two to infinity. But if the parties form "clouds" in policy space, with individual members differing on some issues, then the "correct" number of dimensions becomes an empirical issue.

Producing an accurate empirical measure of the number of dimensions of political conflict in Congress, from the beginning to the present, may be Poole and Rosenthal's greatest achievement. Astonishingly, there have been at most two dimensions, and generally just one, over the course of two centuries! Establishing that empirical regularity is a genuine scientific advance, on a par with breakthroughs in the measurement of physical or biological phenomena in the hard sciences.

Modeling Roll Calls. According to a principal-agent perspective, individual votes reflect the interests of the constituents, efforts by organized interests, or responses to certain informational cues. Poole and Rosenthal reject that view, resting their own interpretation on the centrality of legislator ideology and on evidence that measures of constituency interest perform surprisingly poorly. In the public-choice literature, James Kau and Paul Rubin first advanced that argument ("Self-interest, Ideology, and Logrolling in Congressional Voting," *Journal of Law and Economics* 21 [1979]: 365–84), and many others have done so subsequently. But Poole and Rosenthal's argument goes further: Over time, voting follows a pattern determined by the ideological position of the legislator on at most two recovered dimensions. Once those ideological influences are taken into account, all other ostensible independent variables are irrelevant, except in unusual circumstances. I have been on the other side of this debate at times, but it would appear that Poole and Rosenthal have won a major victory here. Because their nominate scores are available in easily merged, machine-readable format, everyone has access to the measures. It is now established that no better measure of ideology exists, and the publication of *Congress* should lay to rest the lingering belief that other measures, such as "interest-group ratings" (e.g., ADA scores), are valid substitutes for ideological variables.

It may seem that some of the criticisms offered at the beginning of my review are too harsh if I really think so highly of the book. But my criticisms are harsh precisely because I think so much of the accomplishments reported in *Congress* but fear they may go unrecognized because of flaws that could have been avoided. Although some readers may dismiss *Congress* as a technical measurement exercise in the rational-choice tradition, of interest to students of American history but not really of central importance to the discipline of political science, it deserves to be seen as a turning point in the evolution of that discipline.

MICHAEL C. MUNGER
Duke University

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✦ Privatizing Social Security

Edited by Martin Feldstein

Chicago: University of Chicago Press, 1998.
Pp. 470. $60.00 cloth.

Social security used to be called the third rail of American politics, because any politician who touched it was risking political death. Thankfully, that characterization is no longer apt. The impending crisis of Social Security has forced politicians of both parties to think seriously about reform. Although the dominant view in Congress is still that Social Security can be "saved" by a judicious combination of benefit cuts and tax increases, successful privatizations elsewhere have broadened the horizon of the politically feasible. The collection of papers on privatization edited by Martin Feldstein is therefore both timely and vital.

Privatizing Social Security contains ten papers plus comments and an introduction. Five of the papers examine privatizations abroad (in Chile, Australia, the United Kingdom, Mexico, and Argentina). Three papers model the economic effects of various privatization plans in the United States, paying particular attention to the transition path from a government system to a private one. One paper reviews the evidence on how individuals currently structure their voluntary retirement plans. A final paper surveys the evidence on administrative costs in public and private retirement systems.

In the introduction, Feldstein makes a simple but profound point that drives the rest of his analysis. If tax rates remain constant, then a pay-as-you-go Social Security system cannot pay a rate of return in excess of the growth of real wages. Previous generations received high rates of return from Social Security only because the tax rate kept rising (from 2 percent in 1940 to 12.4 percent since 1988). But tax rates cannot rise forever, so the most future retirees can expect to earn on their Social Security "savings" is about 2.6 percent a year (the rate of growth of real wages since 1960.) Over the same period, however, corporate capital has earned a rate of return of 9.3 percent. The difference between what Social Security pays and what an individual could earn with a portfolio of stocks and bonds is equivalent to a tax on labor earnings. The tax is substantial. Following Feldstein, consider a 45-year-old employee who contributes $1,000 to Social Security to "buy" benefits that will be paid at age 75. At 2.6 percent, the $1,000 contributed pays out $2,160 thirty years later. But at 9.3 percent the same $1,000 contribution pays out $14,408! Put differently, to receive $2160 at age 75, the 45-year-old contributor must invest $1,000 in Social Security but only $150 in a private system. Thus, Social Security greatly increases the costs of financing one's retirement.

Like other taxes, the Social Security tax distorts behavior and hence creates the waste that economists call dead-weight loss. (Because individuals expect that some of their contribution will be returned in future years, not all of the 12.4 percent they are

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forced to contribute to Social Security has the effect of a tax. Since a contribution rate of 1.86 percent could generate the same payout in a private system as the current 12.4 percent Social Security rate, the tax rate amounts to 10.54 percent.) Under conservative assumptions, Feldstein estimates that the Social Security tax creates a dead-weight loss of about 20 percent of Social Security revenues ($67 billion dollars in 1995). Social Security probably also causes a substantial drop in private savings, which results in a lower capital stock. Eliminating the dead-weight loss and raising private savings could increase GDP by more than 1.4 percent a year *forever.* Alternatively stated, privatizing Social Security could increase the present value of national wealth by more than 7 trillion dollars. No other policy has anything like that potential for increasing the U.S. standard of living.

Feldstein's second article in the volume, written with Andrew Samwick, is also outstanding. It is often argued that privatizing Social Security will require that today's young workers pay Social Security taxes twice, once to finance their own retirement and once to finance the retirement of current retirees and older workers. As Feldstein and Samwick show, that argument is wrong. Because the rate of return is much higher in a private system, the same retirement benefits can be funded with a much lower contribution rate, just 1.86 percent of wages. Therefore, young workers can fund their own retirement and that of current retirees with a payroll tax of 14.26 percent (12.4 + 1.86). Actually, even that calculation overstates the long-run cost, because it doesn't take into account the increase of national income arising from higher savings and reduced dead-weight loss. Taking those considerations into account and assuming that privatization will be phased in over time, Feldstein and Samwick find that by the twenty-fifth year of the transition, payroll taxes would actually be lower than they are today, and by the sixtieth year taxes would have fallen close to their equilibrium value of 2.04 percent.

Feldstein and Samwick show that the net gains from privatization are very large for today's children and for future generations, positive for today's young workers, and slightly negative for today's middle-aged and older workers. Middle-aged and older workers therefore might vote against privatization (alas, children and future generations do not have a current vote). The gains for children, however, exceed the losses for middle-aged and older adults. Many parents, therefore, might vote for privatization as a gift to their children. (Parents who plan to leave their children bequests would surely do so, because privatization plus a reallocation of bequests could leave every member of the family better off.) In another paper, Laurence Kotlikoff shows that it might be possible to make everyone better off by privatization if privatization were combined with a shift from labor to consumption taxation. Another way to eliminate the redistribution problem is to fund the early years of privatization with sales of government assets such as land. Selling the millions of acres currently held by the federal government would improve the efficiency of the economy at the same time that it smoothed the transition to a better retirement system.

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Thanks to the proselytizing efforts of Jose Piñera, the father of the Chilean privatization, the success of Chile's system has become well known. Sebastian Edwards finds that pensions under Chile's private system are approximately 50 percent higher than pensions in the (slowly disappearing) government system. Although administrative costs were initially very high and are still high by American standards, they are now lower than under the government system. The private system has also fostered higher rates of saving and a much more efficient capital market. Edwards points out quite correctly, however, that we have at least as much to learn from the defects of Chile's system as from its successes. Although Chileans may choose the firm with which they invest their pension savings, the investment funds themselves are remarkably conservative and similar. A large part of the problem stems from a regulation requiring that if a fund's return in any twelve-month period falls more than 2 percentage points below the average fund's return, that fund's management must make up the difference from a capital reserve. Penalized for underperforming but unrewarded for outperforming the average, the fund managers limit their downside risk by following the crowd. As a result, the full benefits of diversification have not been achieved, and Chileans cannot adjust their portfolios to match their preferences for risk.

The United Kingdom's privatization of Social Security, discussed by Alan Budd and Nigel Campbell, is also interesting, because it appears to have been mostly unplanned. Two forces have led to effective privatization: first, the basic state pension was fixed in real terms (instead of increasing with wages, as in the United States); second, the government has gently encouraged voluntary switching to private plans. As a result, the United Kingdom will not have to face the same crisis that looms over other European countries and the United States.

Privatizing Social Security contains many excellent papers that analyze privatization both in theory and in practice, but unfortunately the authors, without exception, accept the premise of social security as given and unchallengeable. But why should the government force individuals to save more than they want to save? It is sometimes said that forced savings are necessary to counter the effects of another government program, the welfare system. According to this view, if individuals know that the government will take care of them in their old age, they will consume everything today and free-ride on the taxpayers later. Of course, some people will free-ride on the welfare system. But how many? Most people choose to work rather than take welfare benefits. Most also choose to save rather than rely on welfare benefits in their old age. It is difficult to believe that the costs of the free-riding that would occur in a voluntary system exceed the costs of the current system. Moreover, the welfare argument implies at most that individuals should be forced to save just enough to avoid becoming a burden on future taxpayers (along the lines of Britain's basic pension). On the welfare argument, it is absurd to force people to "save" 12.4 percent of their earnings up to a high cut-off level. Should the rich be forced to save enough that they can retire in

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the state to which they have become accustomed? Eliminating Social Security altogether is not currently feasible, but political expediency is no excuse for avoiding fundamental questions.

ALEXANDER TABARROK
The Independent Institute

✦ Nixon's Economy: Booms, Busts, Dollars, and Votes

By Allen J. Matusow

Lawrence: University Press of Kansas, 1998.
Pp. xii, 323.

Over the last decade or so, there has been a substantial rethinking of the Nixon presidency. In the aftermath of Watergate, it was impossible to assess Nixon's actions objectively. But as the years have passed, his failures and successes in foreign policy have been examined more dispassionately, and many accomplishments have been noticed. Until the appearance of Allen Matusow's new book, however, Nixon's economic policies had not received a similar reassessment. In a very readable and well researched exploration of Nixon's economics, Matusow makes a compelling case that Nixon held no principled position whatsoever and that his economic policies were overtly and explicitly driven by his attempts to create a new electoral majority. In view of Nixon's having thoroughly politicized the economic-policy process for the purpose of vote-seeking, it is not surprising that his policies were responsible for the worst economic retrogression since the Great Depression. The Nixon presidency, as seen through Matusow's account, becomes an excellent case study in public-choice economics and the failures of interventionism.

Matusow's book is organized largely in chronological order, beginning with 1969 and roughly treating each succeeding year through 1974 in a separate chapter. In some cases where events warranted separate treatment, he has split years into different subject matter (for example, treating the oil shock in a distinct chapter). The more or less linear structure of the book allows the reader to gain a good sense of how Nixon's policies developed and changed over time as his political interests and changing circumstances dictated.

Three major strengths of Matusow's book deserve special mention. First, he has made extensive use of archival materials that were inaccessible until recently. By using the presidential office files, Bob Haldeman's extensive notes, and the various books and recollections of Nixon's associates, he has assembled a large amount of material from a variety of sources to document various meetings and discussions in great detail. The result is a very ugly view of the politicization of economic policy that puts one in mind of the old saw about not wanting to know how sausages or laws are made. Nixon's numerous vices are constantly on display: a hatred of his political enemies and

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a desire to use his power to attack them; his willingness to discard staff members at a moment's notice; his virulent anti-Semitism; and his permanent campaign mode (long before Bill Clinton), especially during his first term.

A second strength of the book, of special interest to economists, is Matusow's careful documentation of the role played by well-known economists in the Nixon administration. Arthur Burns, Herbert Stein, Paul McCracken, Milton Friedman, and others all have starring roles in the drama. Except Friedman, none of them presents an appealing picture. Matusow extensively documents the ways in which Nixon's economic advisors were quick to sacrifice principles, particularly free-market principles, for political expediency. On a variety of issues, from closing the gold window in 1971, to agricultural policy, to energy policy during 1973 and 1974, economists entrusted with political power turned their back on well-established disciplinary positions in the interest of pleasing their political overseers. Friedman operated differently, largely as an informal advisor. Matusow makes extensive use of Friedman's *Newsweek* columns to illustrate the ways in which Nixon's policies did *not* correspond with the Friedman's free-market, monetarist line. Friedman's reluctance to take a position of power served him, and the nation, well by giving him an independent platform from which to evaluate Nixon's policies. One of the undercurrents of Matusow's book is a profound sense of embarrassment about how otherwise competent economists bungled the task of putting their beliefs into practice.

The book's third strength is Matusow's use of economics. In more than three hundred pages of analysis of Nixon's economics, I found very few places where Matusow made an obvious error of theory or history. Perhaps his weakest topic is the budget. He seems to accept the notion that deficit spending is appropriate in times of recession. He also makes a couple of side comments about the deficits of the 1980s that are off the mark. But in most cases he handles the economics nicely, especially in his discussions of inflation, where he keeps the behavior of the money supply always at the forefront, and the energy crisis, where he does a fine job of documenting the various government interventions that precipitated the crisis and the horrendous policy mistakes that exacerbated it. He is particularly hard on Bill Simon, another example of a reasonable man gone astray when entrusted with power. Matusow deserves particular praise for his discussion of Bretton Woods and the gold window, in which he deals with some complicated issues in international monetary economics and does a good job of rendering them comprehensible.

The book's general theme is that Nixon was driven by his own political calculus. Matusow makes a compelling case that Nixon's attempt to build a New Majority that was moderate on economic issues but conservative on social and cultural issues was

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the guiding force of his economic policies: "The zigs and zags of policy gave the appearance of ideological confusion. Politics provided the coherence, and because politics was the point, Nixon cared more about the symbolism of his program—how it played in Peoria—than in actually passing it" (p. 4).

Not long after taking office in 1969, Nixon was already concerned about the effects of the economy on the 1970 congressional election. He wanted to assemble his New Majority as soon as possible and was prepared to use all the tools at his disposal to do so. Matusow documents a conversation between Nixon and George Schultz in the spring of 1970, in which Nixon expressed the hope that Arthur Burns, newly installed as chairman at the Federal Reserve, would loosen up the money supply to boost the economy before the elections. Schultz indicated that Burns "has a way of holding the money supply as hostage—saying that 'if you don't behave, I'll tighten up on money.'" Nixon replied by slapping the table and saying, "When we get through, this Fed won't be independent if it's the only thing I do in this office" (p. 62). Later that spring, Nixon was concerned about high meat prices and was trying to force chain stores to lower their prices in time for the election. Having complained to an aide that the chain stores were "primarily dominated by Jewish interests," Nixon had already instigated an antitrust inquiry when market forces brought meat prices down (p. 66). Not only did he accept that "we are all Keynesians now"; in Nixon's microeconomic world, "we are all interventionists now."

Matusow documents the importance of John Connally's role as secretary of the Treasury. A conservative southern Democrat, Connally embodied Nixon's economics. He found himself more and more an outsider in his own party and more and more welcome in Nixon's movement to create a New Majority. Connally had no fixed principles. In his own words, "I can play it round or I can play it flat, just tell me how to play it" (p. 109). He was a central player in the closing of the gold window (opposed, interestingly enough, by Paul Volcker, then an undersecretary at the Treasury) and the point man for Nixon's broader New Economic Policy in 1971. Always aware of the political implications of any policy moves he made, Connally was the perfect aide for Nixon.

In his discussion of Nixon's various attempts at price controls, Matusow nicely illustrates the problems of attempting to enforce price and wage controls in a complex economy and details the ways in which the institutions responsible for enforcing the controls both lacked the necessary knowledge to do so with any semblance of economic rationality and were buffeted by the winds of political power. Powerful labor interests received exemptions from the controls, as did certain industries. Clearly, Nixon and his advisors thought that the controls would be worthwhile politically, and they convinced otherwise sensible economists to buy their argument.

Although Matusow does not draw out what I see as the moral of the story, it does not take a very deep reading to see that the mess Nixon created is always a possible, if not a likely, outcome when the state has the power to intervene as Nixon did.

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The apparatus of state intervention sits ready and waiting for those willing to use it. If it could be used to enhance economic well-being, then concerns might be misplaced. However, given the complexity of that task and the limited ability of state actors to acquire the knowledge necessary to complete it, inevitably the instruments of intervention will be turned to more parochial uses. Such misapplication is even more likely in an era when politicians are permanently campaigning, so that their explicitly stated goal, like Nixon's, is to get themselves and their party reelected. Matusow has carefully and cogently documented Nixon's use of the instruments of power in pursuit of his own political goals and illuminated the disastrous results (double-digit inflation and the worst recession since the 1930s, not to mention a legacy of interventionism that has continued to the present) that Nixon's economics engendered. Matusow's book, though not couched in such terms, is an excellent case study in public-choice economics and is recommended to students of public choice and recent U.S. economic history.

STEVEN HORWITZ
St. Lawrence University

✦ Ethnic Diversity, Liberty and the State: The African Dilemma

By Mwangi S. Kimenyi

Cheltenham, Eng., and Northampton, Mass.: Edward Elgar, 1997. Pp. viii, 126, paper.

Few Africans today would not regard the state of African societies and their economies as regrettable and a serious embarrassment. After decades of costly struggle to rid themselves of the indignity of colonial domination, people in many African countries find themselves caught up in civil wars, brutal military or civilian dictatorships, economic degradation, and hopelessness. Even where there are semblances of parliamentary democracy, the requisite rule of law, freedom of the judiciary, the press, and association by individuals are often missing. Professor Mwangi Kimenyi writes about this state of affairs in sub-Saharan Africa.

Kimenyi traces the African problem, or dilemma as he terms it, to the diversity of ethnic groups, many of which were forcibly and incongruously placed under common central governments by the Berlin Act of 1885. He concludes that the solution is to redraw the boundaries of African countries so that they become consistent with ethnic identities, because it is apparently impossible for different ethnic groups to live together.

In places, however, Kimenyi does not stick with the logic of his argument, attempting instead to prescribe constitutional designs by which different ethnic groups may yet live together to take advantage of the economies of scale in the production of

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certain social services. His difficulty in following a consistent logic appears to flow from his attempt to equate the African condition with the "Hobbesian jungle" (p. 4) in which life is "solitary, poor, nasty, brutish, and short." That situation, he argues, results from the exercise of unlimited powers by governments; hence he accepts the Lockean prescription of governments whose powers are constitutionally limited. Readers inclined to appreciate the logic of John Locke's argument for constitutionally restrained governments as a means of preserving individual liberty might look forward to the development of Kimenyi's argument in the book, but they will be disappointed.

Kimenyi does not explain why countries in other regions of the world such as Asia, Latin America, eastern and central Europe, and the former Soviet Union did not experience the chaos he calls the "Hobbesian jungle," although their governments acted very much without restraint in violating the rights of their citizens. Indeed, some political scientists have described several African dictatorships as "soft states" precisely because they have been unable to govern "effectively." Chapter 2, "From Tribal Chief to Dictator," portrays African rulers who could never have developed prosperous empires such as Ghana, Mali, and Songhai in West Africa or similar cases in East and Southern Africa, and Nubia.

The discussion of ethnic intolerance in chapter 3 is inconsistent with what one knows of African societies in which the perverse redistributive actions of governments, and the ethnic rivalry that results therefrom, are absent. Indeed, Kimenyi's misdiagnosis that "the primary feature of the Sub-Saharan African countries that poses the most important barrier to reform [is] the high degree of population heterogeneity" (p. 18) and his sense of a high degree of intolerance among those heterogeneous groups create a dilemma for him in chapters 4 through 6. There he attempts to design a constitution for unitary states that nevertheless contain heterogeneous groups. In chapters 7 through 13, he suggests a federal constitution to keep feuding tribes apart.

Most of Kimenyi's analyses and suggestions appear superficial. For example, he urges the stipulation of constitutional civil liberties and a process of constitutional change as if no African constitution had ever contained such provisions. It would have been helpful to provide some textual examination of a few African constitutions to illustrate his claim. It might have emerged that the misperceived role of government as the creator of economic equality (rather than as the agent to create or maintain an enabling environment for individuals to pursue their own economic betterment) has been the primary cause of most civil strife and political tyranny in Africa and around the world. Thus Ghana, first in sub-Saharan Africa to attain political independence in 1957, has as its motto, "Freedom and Justice." Tragically, the independence arch that bears that inscription has been aptly referred to as the spot where freedom and justice were buried by the dictatorship of Kwame Nkrumah in the name of socialism. (Similarly, the 1936 constitution of the Soviet Union contains admirable declarations of the rights of citizens, including the "freedom of speech, the press, assembly, . . . guaranteed inviolability of the person . . . the homes of citizens and privacy of correspon-

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dence" that are laughable when one recalls what happened there under the communists.) Friedrich Hayek's *Road to Serfdom* (1944) contains a very useful study of dictatorships and the brutality of governments, which Kimenyi shows little sign of having read. Kimenyi's implicit argument that federal states are more conducive to economic growth also can be dismissed by casual empiricism.

Kimenyi should have clarified several other arguments. For example, he claims that governments in Africa would like to create "inefficient property rights" (p. 69) in order to facilitate their dictatorships. What are those rights and how are they deliberately created? In arguing the benefits of decentralization of state power, Kimenyi cites Julius Nyerere's Ujamaa socialist experiment, which impoverished the people of Tanzania, as "the best known case . . . in Africa" even though the experiment "abolished private ownership [of land] and replaced it with communal ownership" (p. 71). His attempts to adapt demand and supply analysis to illustrate the "tribal surplus" (p. 34) and "wealth transfers by tribal groups" (p. 47) are at best puzzling.

For their endorsement of the redistributive state, academic leftists may be legitimately accused of complicity in creating the African dilemma, and no one should expect that they can now point the way to its resolution. Therefore, Kimenyi's efforts from the perspective of classical liberalism are a welcome addition to the literature. Unhappily, his analysis will disappoint many who share his philosophical perspective. It lacks depth and seriousness. Careful students of African society—its anthropology, economy, history, and politics—will find much to dislike in the book.

JAMES C. W. AHIAKPOR
California State University, Hayward

✦ The Noblest Triumph: Property and Prosperity through the Ages

By Tom Bethell

New York: St. Martin's Press, 1998.
Pp. 378. $29.95.

Tom Bethell, Washington correspondent for the *American Spectator*, has written a valuable book for economists and noneconomists alike. The seed of the book was a lecture about economic development that Bethell gave to staff members of the International Monetary Fund and the World Bank, who seemed to him genuinely unaware of the importance of private property and the rule of law. The title traces to Jeremy Bentham, who noted that secure private property rights are "the noblest triumph of humanity over itself."

Bethell, apparently self-taught in economics, says Milton Friedman's regular *Newsweek* column stimulated his interest in economics. He was especially impressed by Friedman's consistent focus on incentives. The book's underlying premise is

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"When property is privatized, and the rule of law is established in such a way that all including the rulers themselves are subject to the same law, economies will prosper and civilization will blossom. Of the different possible configurations of property, only private property can have this desirable effect" (p. 3).

Bethell simultaneously develops two themes. First, he describes in detail many historical cases that show how attenuated property rights have shrunk the economic pie. Second, be traces economists' thinking about property and law. Many readers will be familiar with the examples. Even so, it is useful to gather them in one volume.

The examples include the Jamestown and Plymouth colonies, Robert Owen's commune in southern Indiana, the Irish potato famine, the Soviet Union and China, the Arab world, U.S.–inspired land reform in the Third World, zoning, intellectual property, and a multitude of topics under the environmental heading—elephants, rain forests, California water, and the U.S. Forest Service, among others. There is also an entertaining allegory about the hazards confronting residents of an apartment-house complex when they "share" the utility bill.

Most interesting to me were the accounts of the Plymouth colony, the Irish potato famine, and the Arab world. I was unaware that prior to sailing for America, the Pilgrims had opposed the communal arrangement that later nearly caused their complete destruction. (I had always assumed that the Pilgrims were naive Christians emulating the early church.) Their position had been compromised by agents who acceded to demands by the colony's financial backers that output be equally distributed.

Bethell ascribes the Irish potato famine to insecure property rights. Apparently, he caught the scent of the property-rights trail from an 1836 comment of Thomas Malthus on Ireland: "There is indeed a fatal deficiency in one of the greatest sources of prosperity, the perfect security of property." Malthus, however, did not elaborate. Additional suspicion was aroused by others (John Stuart Mill, for example) who attributed Irish poverty to sloth and shortsightedness. Such behavior, says Bethell, is symptomatic of faulty incentives. For example, the English had perpetrated a series of land confiscations that had undoubtedly shortened landlords' time horizons. In any event, the important question for Bethell is why Ireland was poor in the first place, for the famine merely pushed it over the edge. Whether Bethell has all the historical details correct I am not sure, but his discussion is an interesting one.

For the Arab world, Bethell notes that "the brutal punishments meted out to thieves suggest that Arab property is prized and protected. The problem is that there is no security against *the depredations of the state itself*" (p. 225, emphasis added). Land that was once cultivated and productive is now desert. Bethell dismisses the Koran as the source of the difficulty. Instead, he traces the problem to a "freezing" of

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Islamic law in the fifteenth century. Much of the discussion runs in terms of Europe's ascendancy relative to the Arab world after 1600.

If a picture is worth a thousand words, it is unfortunate that Bethell did not include an aerial photograph from the November 1987 issue of *National Geographic*. It shows the border between Haiti and the Dominican Republic, the Haitian side stripped and the Dominican side forested. The difference in property-rights regimes would have made an instructive case study.

With respect to his other theme, economists' thinking about private property, Bethell argues that Adam Smith, David Ricardo, and Thomas Malthus, among others, understood its importance but took its existence as a given. Bethell tells the story of the profession's subsequent long descent toward neglect of private property's importance. So steep was the descent that in the late nineteenth century, Alfred Marshall averred that people could be trained "to feel the public interest as their own." Likewise, Frank Taussig argued in 1911 that a "higher moral sense" would soon make people more public-spirited. (Why do human perfection and collectivism always seem to go hand in hand?)

At issue here is the nature of human character. Are people innately good? Do their vices trace to the influence of a misguided society, so that surrounding them with "healthy" environments will bring forth the ideal society? Alternatively, are people naturally inclined toward egocentrism? Are vices inborn, forcing us to rely on incentive structures that elicit positive, albeit unintended, social outcomes? In his book *A Conflict of Visions,* Thomas Sowell argues that these two perspectives on human character (his "unconstrained" and "constrained" visions) lie at the heart of all political controversies.

Curiously, Bethell contends that support for the "innately good" proposition has waned under the weight of the evidence that reliance on it does not work. Perhaps 1999's counterparts to Marshall and Taussig would not espouse nonsense about people's identifying with the public interest. Nevertheless, plenty of people act as if they have reached a state of perfection, and they are more than ready to reproduce themselves in us. Try talking to environmentalists.

Bethell locates the property-rights renaissance in the economics profession in the late 1950s and early 1960s at UCLA and Chicago. Armen Alchian and Ronald Coase figure prominently in the discussion. Unlike Smith, Ricardo, and Malthus, however, Alchian and Coase confronted an intellectual milieu that did not accept the importance of property rights. They, along with other property-rights theorists, had to work hard to get their foot in the door, as did their close professional relatives, the public-choice economists.

Monocausal explanations such as Bethell's are always risky. One question that kept coming to me as I read his case studies was how to account for Sowell's evidence that certain racial and ethnic groups have consistently outperformed others. For example,

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what accounts for the success of the Chinese overseas migrants? Property-rights institutions cannot provide the answer. In any event, there is no question that private-property rights and the rule of law are, as Bethell states, the only arrangements that result in high overall living standards and personal freedom. Bethell is to be commended for explaining that fundamentally important idea in a readable and instructive way.

T. NORMAN VAN COTT
Ball State University

✦ Privacy in the Information Age

By Fred H. Cate

Washington, D.C.: Brookings Institution Press, 1997.
Pp. 248. $39.95 cloth, $16.95 paper.

For advocates of the liberal social order—a society in which the rights to life, liberty, and property are recognized—the issue of privacy is a thorny one. Although we tend to believe, in general, that we ought to be able to maintain our own privacy, we recognize that information about us is, to the extent that it is property at all, a very peculiar kind of property.

And make no mistake: privacy is about information. As Alan Westin wrote in *Privacy and Freedom,* it is "the claim of individuals, groups, or institutions to determine for themselves when, how, and to what extent information about them is communicated to others." For the liberal, the first problematic aspect of the issue is the uncertainty concerning who owns information about individuals, groups, or institutions. Suppose, for example, that Smith sees Jones in the supermarket. Presumably, Smith has a right to that information; the supermarket is, after all, a public place, and he has as much right to be there and to observe as anyone else does. But what right does Smith have to dispose of the information? May he sell it or give it away to anyone he wishes?

Of course, Jones is unlikely to claim a right of privacy about the information that he was in the supermarket at some particular time, so he is unlikely to contest Smith's giving or selling that information to someone else. But such acceptance is not always the case: suppose Smith saw Jones buy a very expensive piece of jewelry. That information could have value to, say, another jeweler, who might annoy Jones with unsolicited advertising, or to a jewel thief, who might do more than annoy Jones.

Suppose Smith observes Jones's conviction for stealing a piece of jewelry. After Jones serves his time in prison, he applies for a job as a jewelry salesman at Johnson's jewelry store. Does Smith have the right to tell Johnson about Jones's previous history as a jewel thief? Or must he keep that information private, thereby leaving Johnson at substantial risk?

Does Jones have any right to prevent Smith from selling or giving away that information? If Jones has a right to all information about himself, plainly none of that

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information may be transferred or traded by others. But if the information is Smith's property—as it would seem to be by most liberal theories, because Smith acquired it by his own effort—then evidently Smith has a right to transfer the property in any way he wishes.

The problem is complicated further by another characteristic that distinguishes information from other property: it can be transferred without diminution. If Smith tells Johnson about Jones's history as a jewel thief, then both Smith and Johnson can use the property. In that respect, information is quite unlike physical or ordinary intangible property: if Smith gives Jones a hammer, a piece of real estate, or some shares of stock in a corporation, then Jones enjoys the benefits of owning those articles of property and Smith no longer does.

Furthermore, the cost of replicating information seems to be in constant long-term decline. Four millennia ago, information could be duplicated from one person to another only if someone orally related it and someone else processed it into his memory. Such transfer was both cumbersome and relatively unreliable. Two millennia ago, information could be encoded and stored, but the process (handwriting) was very labor-intensive. Half a millennium ago, information could be mass produced by printing, a huge improvement but still an expensive process unless a large number of copies were needed. A half-century ago, information could be reproduced by copying machines. For the first time, small quantities of information could be stored and reproduced in small quantities at a relatively low cost: a sheet of paper could hold approximately 5,000 characters, or 5 kilobytes of information, at a cost of about 5 cents per kilobyte. Today, anyone with a microcomputer can duplicate 650 megabytes of information—the entire Encyclopedia Britannica, for example—at a cost of perhaps $1.00, or about 0.00015 cents per kilobyte.

The upshot is that if Smith can get useful information about Jones, he can reproduce and distribute it very cheaply. Consequently, Smith can afford to go to considerable expense to get useful information about Jones. But he probably doesn't have to: the same technology that makes reproduction and distribution of information cheaper also lowers the cost of its acquisition.

If Jones shops at an up-to-date supermarket, its computer keeps a record of all his purchases, and anyone with access to that information can learn a great deal about Jones: that he prefers health food, or smokes cigarettes, or drinks wine, or eats fatty foods, or buys condoms or pornographic magazines, etc. If that information belongs to the supermarket and not to Jones, as liberal theory seems to suggest, what is to keep the supermarket from selling it? What prevents marketers, or the government, from compiling an elaborate database on the entire population, complete with information about people's medical treatment, what they purchase, where they travel, the Internet sites they visit, the content of their electronic mail and telephone conversations, and nearly every other aspect of their individual lives?

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And don't think such a database cannot be compiled. The technology already exists, and current databases maintain a substantial amount of the requisite information in very accessible files. And the data will continue to grow and to become more accessible and transferable at ever lower cost.

What is the state to do, if anything, about this situation? In *Privacy in the Information Age,* Fred H. Cate surveys the problem and summarizes the approaches to privacy embodied in American and Western European law. In general, the European approach is to create a powerful regulatory body to control the purchase and sale of information, whereas the American approach is, within certain boundaries, to allow the market to deal with the problem. He concludes with an intelligent speculation about the future of the law of privacy. "The government should play a circumscribed role," he writes, "limited primarily to articulating principles for information privacy, enacting laws when necessary to protect the rights outlined above, adjudicating disputes concerning such rights, facilitating discussion, education, and cooperation, and leading multinational negotiations to resolve conflicts among competing national privacy laws."

He adds three appendixes: the European Union's privacy directive of October 24, 1995, a report on the National Information Infrastructure, and a summary of the discussion of his book by experts at a conference prior to its publication. The first two of the appendices contain useful information, but are a bit dry. I suspect many readers will skip them. But I am glad they were included, because they contain useful information about what is happening now in the area of privacy law.

Cate is an expert in the best sense of the word. He knows the technology and the law; he understands how information is acquired and traded in the private sector; and he has given the whole matter a great deal of thought. He judiciously keeps his conclusions tentative, but readers respectful of the liberal social order, and thus dubious about the merits of government intervention beyond the enforcement of contracts, will find a great deal of merit in his work. So, for that matter, will those who are dubious about the ability of individuals acting in the marketplace to deal with problems of this sort. Whether one agrees with Cate's tentative conclusions or not, his mastery of the subject and the clarity of his exposition make *Privacy in the Information Age* a valuable and thought-provoking book for anyone concerned about either his own privacy or the way personal and institutional information is controlled as its accumulation and dissemination become easier and cheaper.

R. W. BRADFORD
Liberty Magazine

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Etceteras . . .

We're All Sick, and Government Must Heal Us

In recent decades a portentous cultural change has been gathering momentum in the United States, giving rise to dangerous social and governmental developments. Increasingly, Americans have embraced a *therapeutic ethos.* Actions previously understood as irresponsible, imprudent, immoral, or even evil have come to be understood as symptoms of underlying diseases that ought to be treated or cured rather than condemned or punished. More and more people have been declared, or have declared themselves, "victims." They take themselves to be suffering, if only from hurt feelings, because others—parents, schoolmates, coworkers, people at large—have somehow infringed their asserted personal right to health and happiness. To a growing extent, governments have become involved in "treating" these newly perceived ills, and in doing so they have in effect asserted a novel raison d'être, a new justification for their claims to legitimacy. Because the governments' new claims to legitimacy have comported so well with the public's own understandings, little resistance has arisen to the proliferating therapeutic programs at all levels of government.

James L. Nolan, Jr., has written an impressive and disturbing book about these developments, *The Therapeutic State: Justifying Government at Century's End* (New York: New York University Press, 1998). Nolan's study is conceptuallly well motivated and empirically well validated; his presentation is soberly balanced and smoothly written. Sociological research does not get much better than this. Notably, Nolan concludes the study by considering the implications of the developing therapeutic ethos for liberty, and he finds those implications unsettling.

The Therapeutic Ethos

Everyone will have noticed some aspect of the emerging therapeutic ethos. Where once we had Alcoholics Anonymous and its twelve-step program, we now have countless *XYZ* Anonymous groups, each with its own twelve-step remedy. No longer is heavy drinking, cocaine use, or pummeling one's spouse merely indicative of unwise or cruel choices by the perpetrators; instead, such behavior is indicative of an underlying disease. Hence it would be improper, even pointless, merely to censure or penalize

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the perpetrators. Rather, those who suffer from the diseases of alcoholism, drug addiction, or violent abusiveness of a spouse should be treated, and a government operative—a social worker, a judge, a public health doctor—is an appropriate agent to administer the treatment. Along the way it will prove essential that the sufferer recognize and admit that he has the disease. To do otherwise would be to remain "in denial," perhaps the most abominable and unacceptable condition in the eyes of those who embrace the therapeutic ethos.

Sit Still, Johnny

In the new world of the therapeutic ethos, curing the children plays a leading part. In olden days, some children chafed under the discipline and regimentation of the schools. Some kids just wouldn't sit still; others were downright naughty. No longer. Now they, along with any others who fail to respond with zombie-like responsiveness to the school regulations, are diagnosed as victims of attention deficit disorder (ADD). (Look it up. The official guide is the American Psychiatric Association's *Diagnostic and Statistical Manual of Mental Disorders, Third Edition, Revised* [commonly called the DSM III-R].) For ADD, which "experts" believe afflicts 5 percent of all children, the prescribed treatment is a drug called Ritalin. In some cases children have been refused admission to schools, which the law requires them to attend (*gotcha!*), because their parents objected to the children's taking Ritalin. (Nolan cites Diane Divoky, "Ritalin: Education's Fix-It Drug," *Phi Delta Kappan* 70 [April 1989]: 599–605.)

Build Self-Esteem

For an astonishingly wide spectrum of behaviors, adherents of the therapeutic ethos view the underlying disease as itself the product of deficient self-esteem. To anyone under the impression that the self-esteem movement is little more than another flaky California fad, Nolan's documentation will prove shocking. It seems that everything from mathematical ineptitude to teen pregnancy to first-degree murder is now viewed as stemming from insufficient self-esteem.

> By the middle of 1994, some thirty states had enacted a total of over 170 statutes that in some fashion sought to promote, protect, or enhance the self-esteem of Americans. The majority of these (around seventy-five) are, not surprisingly, in the area of education. There are additionally at least twenty self-esteem-related statutes in health care, over forty in welfare or social services, and approximately sixteen in the area of corrections or criminal justice. (Nolan, *The Therapeutic State,* p. 157)

Besides uncountably large numbers of touchy-feely Democrats, such prominent Republican figures as Jack Kemp, Barbara Bush, and Colin Powell have come out in support of the self-esteem movement.

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Not to be outdone by the states, a number of federal government agencies have issued regulations making reference to the building of self-esteem (Nolan, pp. 324–26). Believe it or not, one such regulation was the Commerce Department's 1986 "Northern Anchovy Fishery: Notice of Final Harvest Quotas" (51 FR 32334, cited by Nolan, p. 325). Is nothing sacred?

The Experts Tell Us . . .

In parallel with the spreading therapeutic ethos, psychologists have established themselves as bona fide experts, and they have played an expansive role as courtroom advocates of tort remedies for persons claiming to have suffered emotional distress. Beginning in 1946 and ending in the 1970s, all the states adopted licensing statutes for psychologists. "Often, state courts justified the admittance of psychologists as expert witnesses on the basis of the licensing statutes passed by their state legislature. Somehow licensing codes gave credence to the idea that the psychologist was a legitimate expert" (p. 70).

One upshot is that nowadays "therapeutic practitioners, with unprecedented 'expert' authority, provide the courts with psychologically inspired interpretations about human behavior, motives, criminal activity, and truthfulness" (p. 76). In such judicial proceedings "the state becomes involved not only in the evaluation of behavior but in an assessment of the internal processes of individual psyches" (p. 297).

Therapy Will Win the War (on Drugs)

State and federal prisons brim with persons convicted of drug offenses. Those prisoners have become abundant grist for the mills of the therapeutic state. In 1962 the U.S. Supreme Court ruled that "states could compel offenders to undergo drug treatment." In 1966 the federal Treatment and Rehabilitation Act "gave the courts statutory authority to commit drug offenders involuntarily to residential and outpatient treatment programs as an alternative to incarceration." As Nolan remarks, "With these changes, the stage was set for the conflation of criminal law and therapeutic drug treatment. A number of organizations and agencies sprang up to fill this opening" (p. 81).

One such newcomer was the so-called drug courts, which have been established in hundreds of jurisdictions across the country. Despite the failure of these special courts to reduce recidivism, their popularity has grown merely because of their approach, which is to treat drug offenses as pathological outcomes rather than ordinary crimes. A drug court transforms a judge into a sort of police-backed hyperintrusive schoolmarm who scolds, praises, or threatens the "clients," depending on how well they play along with the program (pp. 78–112, 295–96).

In 1966 the Narcotic Addict Rehabilitation Act required treatment for federal drug convicts in prison, and by 1990 more than 218,000 prisoners were enrolled in related counseling programs (p. 113). In the state prisons, by 1990, more than

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42 percent of the inmates were enrolled in a therapy or counseling program of some sort (p. 115). Although the programs take various shapes, common threads include "emphases on the primacy of self and the centrality of emotions, the view of the inmate as a patient in need of healing, and the assumption that abusive and victimized pasts predispose one toward crime" (p. 120). Not even the get-tough-on-crime reaction of recent years has deflected the application of the therapeutic ethos to the operation of the prisons.

Kid Stuff

In the schools, as in the prisons, the central objective is now to "cure" the children by promoting their self-esteem. According to Rita Kramer, the author of *Ed School Follies,* "Self-esteem has replaced understanding as the goal of education" (quoted by Nolan, p. 150). One must admit that the schoolteachers and counselors have had a large measure of success in their main endeavor. Although in international comparisons American students rank very low in math, science, and other educational attainments, they rank very high in their own evaluation of their abilities (p. 169).

Although saving the children has long served to justify extraordinary governmental measures, this rationale has become well-nigh universal in recent years. Among the sacred cows of the child-savers, the Head Start program, begun in 1964 as part of the War on Poverty, commands special veneration. Among other achievements, Head Start gave rise to a program known as "Telephone Friends," allowing lonely old people to talk to young children on the telephone. According to Congressman Ben Erdreich, this "truly gratifying endeavor" improved "self-worth and self-esteem for both seniors and children alike" (quoted by Nolan, p. 216).

Nolan observes that "the state's role toward children was viewed [in Congressional debates] as most appropriate when some form of therapeutic assistance was provided" (p. 217). That legislative perspective no doubt contributed to the authorization of federal funding for Parents Anonymous (PA), established in 1974. "Based on the self-help model of AA, the program provided a forum where parents with the 'sickness' of child abuse could get help. Not surprisingly, the help they sometimes needed was assistance in attaining a higher view of the self" (p. 219). One wonders whether any member of Congress has ever introduced a bill to establish Tenth Amendment Violators Anonymous (TAVA)—the desperate need for such a group seems obvious.

Don't Worry, It's Good for You

Every smart ruler understands that the best kind of state coercion is the kind that subjects do not regard as coercive. By resorting increasingly to just that sort of coercion, American governments have succeeded in expanding into whole new domains of private life while provoking scarcely a word of protest.

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> The ideals of a "scientifically" based, therapeutic understanding of the world are so embedded in American culture that overt coercion is rarely necessary. Instead, most citizens naturally comply with programs and policies based on therapeutic rationales, because they are so "obviously" plausible. The basic nature of the coercive and expanding state, then, has not changed. What has changed is the source of legitimation by which the state justifies its continued expansion—an expansion that, through use of therapeutic symbols, can move into realms of societal life once left untouched by the state. (p. 298)

Thus, while many freedom-loving citizens have been fighting the growth of government at the front door—and even imagining that they are winning the fight—governments at all levels have been streaming through the back door. Having supposed that Orwell's *1984* has been averted, people may yet wake up to find themselves situated in Huxley's *Brave New World*.

ROBERT HIGGS

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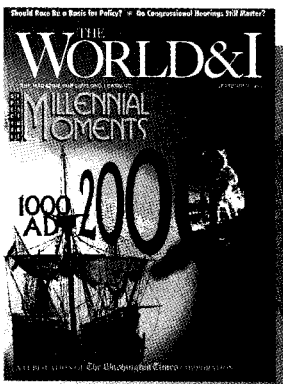

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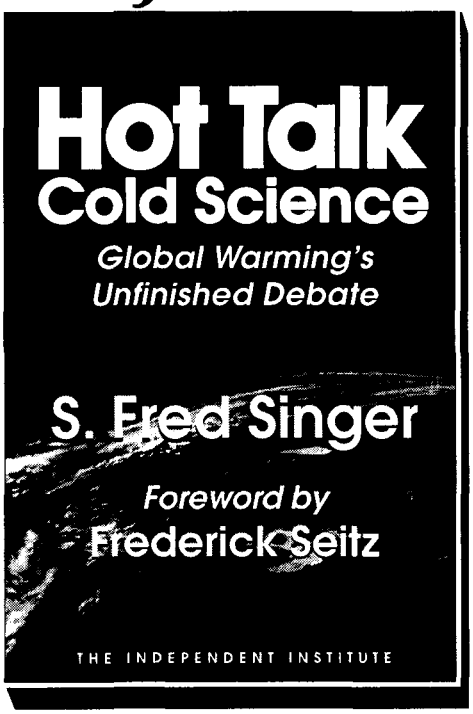
IS GLOBAL WARMING JUST HOT AIR?



Media reports often assert that global warming is real, imminent, and a threat to human life. But, have such predictions been established scientifically? Studies by the United Nations' Intergovernmental Panel on Climate Change (IPCC) have been used (or misused) to call for extensive government controls to reduce fossil fuel use. Yet, the IPCC's own report—and statements by leading scientists—indicate that this issue is far from settled.

In ***HOT TALK, COLD SCIENCE***, renowned astrophysicist Fred Singer brings readers his intimate familiarity with the scientific literature—including studies overlooked—to shed light on one of the most important issues of today. Lay readers and specialists alike will profit from Singer's concise yet masterful discussion of the climate record; computer models; the effects of clouds, oceans, aerosol cooling, solar variability and greenhouse gases; sea levels; crop yields; climate-change mitigation; and more.

Singer shows that climate science does not support *any* consensus for global-warming pessimism. Unless the public comes to recognize this fact, policymakers may implement massive "carbon" taxes and other controls that put society—especially the most disadvantaged—at great risk.

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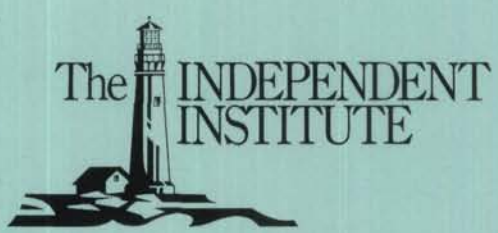

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